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The Morgan Guaranty Survey

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The Improving Inflation Outlook

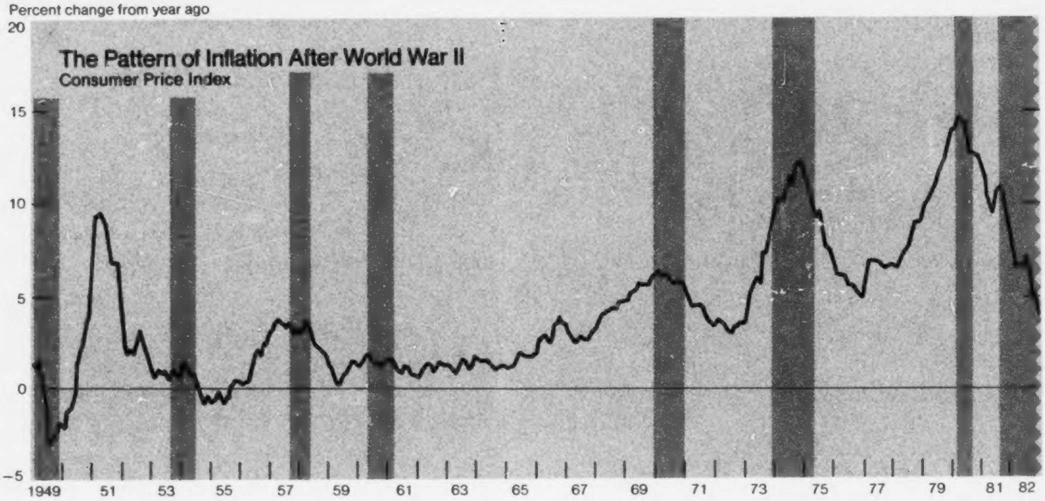
IN December the consumer price index dropped for the second time in the past 12 months. The last year in which the CPI fell even once was almost two decades ago. Although the recent declines are clearly aberrations—the broad trend in prices is still upward—they are indicative of the vast improvement that has occurred.

A number of factors—including lower oil prices, improving productivity, and a slowing trend in wage-rate increases—have combined of late to produce the best inflation readings since the early 1960s. In the last 12 months the consumer price index rose just under 4%, as against a rise of almost 9% in the preceding 12 months. Moreover, inflation has fallen below its low point during the previous economic cycle (chart on page 2). The last time inflation ratcheted down rather than up over the course of a business cycle was in the 1950s.

The slowdown has been due in part to the weakness of oil and food prices. But increasingly the improvement is becoming more general. This can be seen in trends in so-called underlying inflation—that is, prices excluding food, energy, and housing costs. During the past 18 months this measure of underlying inflation has decelerated sharply (chart at upper left on page 3).

A major easing in wage pressures has made a big contribution to better price performance. The index of average hourly earnings has risen by significantly less than 6% in the past twelve months (chart on page 3). This is the smallest increase in wage rates since 1968.

Added progress on the inflation front can be expected this year. That would be consistent


The Pattern of Inflation After World War II
Consumer Price Index

Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open.

with the pattern during past economic cycles when inflation usually did not reach bottom until a year or more after the economy had started to recover.

The sag in oil prices is a major contributor to the outlook for continued improvement. Falling oil prices could directly reduce the inflation rate in 1983 by one half percentage point. In addition, lower oil costs should help reduce inflation expectations and the rate of wage increase. For example, the quarterly cost-of-living escalation formulas used by such unions as the auto and steelworkers are likely to produce a reduction in wage rates when recalculated during the next few months—the first time that has ever happened. A more detailed discussion of the impact of lower oil prices is contained in the story on page 5.

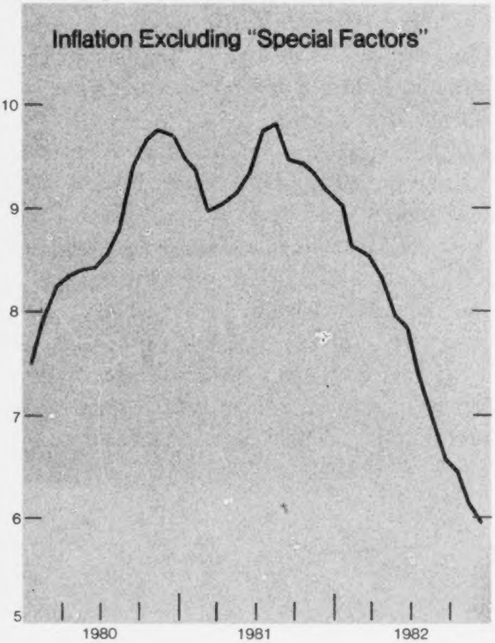
Finally, a dramatic improvement in productivity—output per worker—argues persuasively for a continued drop in the inflation pace this year. In the 1970s, productivity growth de-

Productivity: Actual and Cyclically Adjusted

Percent change, year over year; private nonfarm sector

	Actual	*Cyclically adjusted*
1970	0.5	2.2
1971	3.3	2.7
1972	3.6	2.2
1973	2.6	2.1
1974	−2.2	−0.5
1975	1.8	3.4
1976	3.2	1.5
1977	2.2	1.4
1978	0.6	0.3
1979	−1.3	−1.0
1980	−0.9	0.6
1981	1.4	1.5
1982	0.2	2.1
1982 (Q4 over Q4 1981)	1.8	3.0

Percent change from year ago



Note: Consumer Price Index excluding food and energy prices and the cost of home purchase and finance.

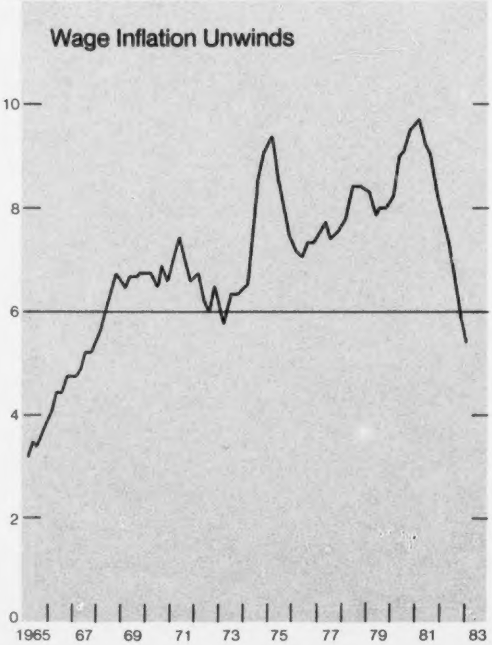
teriorated to essentially zero at the end of the decade from a growth rate of 2½% at the beginning of the period. That deterioration accounted for approximately half of the speedup in inflation that occurred during the 1970s. In the past two years, however, productivity growth appears to have resumed (table on page 2). Between the fourth quarter of 1981 and the fourth quarter of 1982 productivity rose—despite the recession. When the actual performance of productivity is adjusted for the estimated impact of short-term swings in the economy, productivity growth in 1982 was over 2%, its best performance since 1975.

A continuation of improved productivity performance combined with the slowdown in the rate of increase of wage rates means that unit-labor costs—which put a floor under prices—in 1983 could well be increasing at a rate of only about 3% per year, the lowest in a decade.

Beyond 1983

Whether inflation continues to slow or reaccelerates beyond 1983 will depend critically on the policies pursued in Washington. Despite the increasingly apparent success of the Federal Reserve's anti-inflation stance, its continuation cannot be assumed. A fundamental uncertainty is the extent to which policy can continue to be as heavily oriented toward disinflation as it has been. Monetary authorities will be operating in a climate of worry that recovery will be subpar and in which unemployment will be hovering at or near its postwar high.

Percent change from year ago



Note: Average hourly earnings adjusted for overtime in manufacturing and interindustry employment shifts. Latest plotting is for January 1983.

Both monetary and fiscal policy were, of course, used aggressively to speed recovery following the 1970 and the 1974-75 recessions. An effort was made to deal with the inflationary consequences by implementing wage and price controls–mandatory following the 1970 recession, "voluntary" after the 1974-75 recession. The failure of these policies to control inflation or to reduce unemployment on more than a temporary basis (both inflation and unemployment ratcheted up during each of these cycles) makes recourse to decisively stimulative policies less likely now. Even so, exclusive preoccupation with disinflation is obviously unlikely in an environment of over 10% unemployment.

In that setting, the Fed faces a difficult task: to encourage economic expansion without at the same time fostering a new spurt in inflation. The Fed's success in walking that line will importantly influence inflation's path in the period ahead.

Significantly, however, the improvement in inflation that already has occurred is not likely to be entirely lost. The sag in oil prices is not expected to end any time soon. Wages–and unit costs–are moving in the right direction and this is not likely to be reversed in a hurry. Given those trends–and a little luck–price inflation could ease to the 2%-to-3% range by mid-decade. In any case, there is little chance of a return to the double-digit inflation peaks of the 1970s.

Lower Oil Prices: Impact on U. S.

THE failure of OPEC to reach an agreement on production and pricing has resulted in a further drop in spot-market oil prices and in the official prices of a number of non-OPEC producers, including Egypt and the Soviet Union. The general expectation now is that official OPEC prices will fall in coming weeks.

Surprisingly, a debate has arisen as to whether or not an oil price decline is a good or a bad thing. At one level the answer depends entirely on where you stand: if you produce oil it's bad, if you consume oil it's good. At a more basic level, however, an oil price decline is beneficial for the U.S. economy and for the vast majority of Americans.

The oil-price increases of the 1970s were basically a symptom of a constraint faced by the economy. To the extent that the supply of and the demand for oil were relatively insensitive to its price, a limit on the supply of oil could impose a constraint on output–or, at the very least, would mean that very large amounts of resources would have to be used to overcome the limitation on oil supply.

The goods news in the recent decline in oil prices is that oil supply and demand are not as inelastic as had been thought. The supply of oil from countries outside of OPEC has risen steadily in recent years and demand has contracted sharply in response to higher prices (as well as the recession). These responses are, of course, one factor putting downward pressure on oil prices. More fundamentally, they mean that oil is not likely to be a constraint on economic growth in coming years.

A point to remember in analyzing the impact of lower prices is that prices have been falling for two years. The cost of foreign crude to U.S. refiners peaked at close to $39/bbl in early 1981 and by the end of 1982 had fallen to $33/bbl. If the impact of general inflation is taken into account, the decline has been even sharper. In real terms, the price of crude doubled between late 1978 and early 1981. Since then, close to half of that rise has been erased.

Most forecasts of oil prices for 1983 are in the $25/bbl-to-$30/bbl range. If average prices were to dip to $30/bbl, it would represent a continuation of the rate of decline experienced over the past two years. If prices break to $25, however, that would represent a significant increase in the rate of decline. Wholesale prices of oil products in the U.S. have already fallen to a level consistent with crude at somewhere near $27/bbl. Consequently, if crude prices hold at $30/bbl, product prices would actually rise, and a drop to $25/bbl would only push wholesale product prices down modestly.

A $5 drop?

What if oil prices drop $5 a barrel? Here are some of the effects on the U.S. economy:

Incomes. A $5/bbl drop in the price of oil would save oil users in the U.S. $27 billion per year. Most of this saving would accrue to consumers directly through lower costs for gasoline and home heating oil. There would also be some indirect benefits as businesses passed through part of their savings in lower prices. Of the $27-billion gain to consumers, about $8 billion would come at the expense of foreign oil producers. The remaining $19 billion would represent, initially, a decline in the income of domestic producers. Something like 70% of this ($13 billion), however, would be offset by lower windfall profit, income, and severance taxes. Thus the biggest losers in an oil price decline are likely to be federal, state, and local governments.

Inflation. The direct impact of a $5/bbl (12¢ per gallon) drop in oil prices would be to reduce the consumer price index by 0.6% in 1983. In addition, however, the index would benefit from lower prices for goods and services, such as air travel, that use large quantities of oil. This indirect impact might reduce the CPI a further 0.2% or 0.3%. The initial reduction in inflation, furthermore, would tend to lead to additional improvement through its influence on wage rates. This would happen automatically through reduced cost-of-living escalation under labor contracts and as decisions by nonunion employers began to reflect the better inflation performance. All told, a $5/bbl drop in the oil price might lower the CPI by 1% within a year.

Trade balance. With net oil imports running at a rate of approximately 4.5 million barrels per day, a $5 drop in the price of oil would reduce the trade deficit by $8 billion.

Real output. Lower oil prices would have two immediate effects on demand for goods and services. They would boost consumer spending through sizable additions to consumer purchasing power. They also, however, would reduce energy investment as oil industry profits fell and the expected returns from energy exploration declined. Whether the net result would be positive or negative is not clear.

A second impact from lower oil prices on demand is possible through monetary policy. With inflation lower, the monetary authorities might well have more latitude to bring interest rates down. If that happened, the effect would be a major economic stimulant.

Economy Watch

THERE is now little doubt about it: the U.S. economy is beginning to emerge from the recession. Orders are rising and inventories have been greatly reduced, a combination that almost inevitably means higher output during the next few months. Especially promising is the fact that employment increased in January, following sharp declines in the closing months of 1982.

Part of the improvement last month in employment—and in average hours worked and the jobless rate—may have been due to unusually mild winter weather. Indeed, in announcing that joblessness fell from 10.8% in December to 10.4% in January, the Bureau of Labor Statistics acknowledged that seasonal adjustment problems may have "exaggerated the December to January change."

Other special factors apparently played a role. Because retailers were cautious about Christmas hirings, for instance, the normal seasonal decline in retail jobs did not occur in January. (Seasonally adjusted, retail jobs rose sharply, and, in fact, accounted for seven out of every ten new jobs reported in January.) The anomalously large January decline in the labor force, which cannot be expected to persist, also suggests that the underlying improvement in labor-market conditions was not so great as the fall in the unemployment rate indicates.

Even so, the improvement in labor markets —along with other recent readings of economic performance—suggests a need for upward revision of real GNP estimates for the current quarter. The Morgan Bank's forecast anticipates 3.8% growth in real GNP in the first quarter, three-quarters of a percentage point above last month's estimate.

Much of the momentum in the economy comes, as it has for several months, from the housing and auto industries. Housing permits in December were almost 40% higher than at mid-1982. Builders apparently are confident that the reduction of almost four percentage points in mortgage rates since midyear, and the accompanying drop of about $165 per month in the cost of carrying a median-priced house, will make for continued improvement in home sales. Similarly, the stepup in domestic-make auto sales—to an annual rate of 6.3 million units in the past three months from a rate of 5.6 million units in the previous three months —has been encouraging. Just as in housing,

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

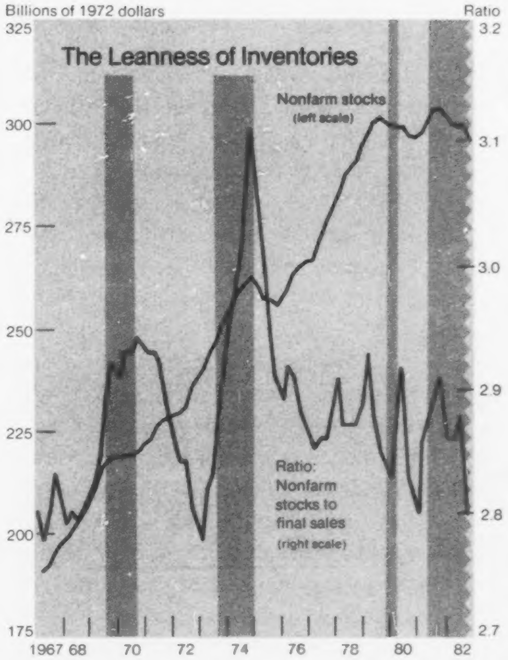
	1982	*1983*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−2.5	3.8	2.9	4.3	5.1
Real consumer spending	5.0	3.1	2.7	3.2	3.6
Real business-capital outlays	−9.0	−10.2	−0.1	2.5	4.2
GNP deflator	4.3	3.8	5.5	4.3	4.5
Consumer prices	2.6	0.3	4.8	5.6	5.8
Real disposable personal income	−0.2	1.6	0.9	3.0	4.1
Saving rate (%)	5.8	5.5	5.1	5.1	5.2
Housing starts (Millions)	1.3	1.4	1.5	1.6	1.6
Auto sales (Millions)	8.7	8.8	8.8	9.2	9.5
Unemployment rate (%)	10.7	10.6	10.8	10.8	10.8

NOTE: 1982 Q4 data are actual.

carrying costs have come down sharply—about $25 per month since mid-1982, for the average car financed with a four-year loan at the concessionary rates now being offered by Detroit.

Above all else, though, it is the recent massive drop in inventories that bodes well for an upturn in real GNP in the current quarter. Inventory drawdowns ran at a record rate—$18 billion measured in 1972 dollars—in the fourth quarter of last year.* That alone would have reduced real GNP at an annual rate of 5% had final sales shown no improvement in the quarter. Such sales rose, however, at a rate of 3¼% —paced by home building and auto sales, and by federal government purchases of goods and services.**

Auto inventories have been pulled down below desired levels, paving the way for a recall by General Motors and Chrysler of over 20,000 assembly workers last month. Inventories of such key semiprocessed goods as steel and lumber also appear to be sparse. Rising orders led to impressive increases in production in both industries last month. Even so, lumber prices were bid up sharply; rising commodity prices generally point to a firming in industrial-product markets that makes it unlikely that anything like the recent pace of inventory drawdowns will continue. Further deep cuts in stocks conceivably could mean delivery problems and lost sales opportunities. Indeed, surveys of purchasing agents are beginning to reflect slower deliveries.



Note: The stock-to-sales ratio is based on business final sales – that is, total final sales (GNP less inventory investment) less the gross product of nonbusiness sectors such as government. Final sales are calculated at monthly rates, so that the ratio represents the number of months it would take to exhaust the outstanding stocks at the prevailing sales rate. Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open.

Over all, inventories are lower in absolute terms than at any time in the past four years (chart on this page). Relative to final sales, inventories are also lean. By the end of last year, they were appreciably lower than in the late stages of past recessions. The inventory-to-sales ratio in late 1982, in fact, was in line with those of boom years such as 1973 and the late 1960s when some goods were in scarce supply.

Even with the lift from an inventory swing, however, the persistence of relatively high interest rates and a variety of sectoral problems —ranging from financial stress on states and localities to the worsening U.S. trade balance

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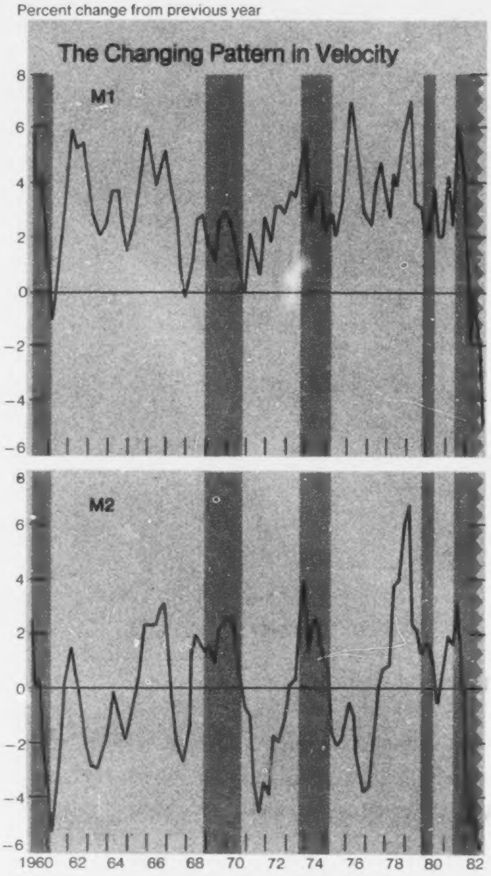
*This preliminary estimate for the fourth quarter is likely to be revised to show an even larger drawdown, because inventory liquidation by manufacturers in December was unexpectedly large.

**Much of the fourth-quarter increase in final sales came from stepped-up purchases of agricultural commodities under CCC loan programs, and these are unlikely to continue at the fourth-quarter pace. Even so, rising final sales ex that special factor and declining inventories at the end of last year bode well for a pickup in output in the next few months.

—portend subpar recovery. The Morgan Bank's forecast looks for an increase in real GNP of 4.0% during the year, some two-thirds of the norm for the first four quarters of a cyclical upswing. Such growth, in all likelihood, would be inadequate to reduce the unemployment rate from the December-January average of 10.6%. Rather, joblessness is expected to inch up in the near term and level out only from midyear on—reflecting in large part continuation of relatively rapid growth in output per worker in line with trends in recent quarters. Projections of the unemployment rate (table on page 7) assume that the December-January average gives an undistorted reading of the recent level.

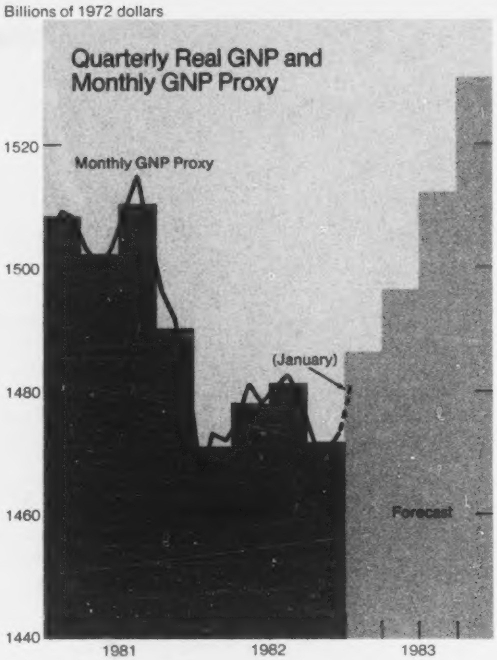
With only subpar economic performance in prospect, a further drop in interest rates would be helpful. The Federal Reserve's latitude for nudging rates lower may be more limited than in past recovery periods, given the growth that has prevailed recently in the monetary aggregates. It is difficult, however, to fathom the significance of rapid money growth; such growth has been distorted by great change in the holdings of deposits and other financial assets by the public. The Fed's decision to redefine M2 testifies to the need for special caution in interpreting movements in the aggregates. Presumably when Chairman Paul Volcker gives his semiannual Humphrey-Hawkins testimony on February 16, he will emphasize that the Fed intends to avoid getting locked into rigid adherence to aggregates targeting.

The sheer magnitude of deposit churning since the new money-market deposit accounts (MMDAs) were introduced in mid-December demands caution. Some $213 billion were moved into MMDA accounts as of the week ended January 26. Super-NOW accounts grew to $17 billion.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open.

And it isn't just the new accounts that have made interpretation of the aggregates especially difficult. All of last year, M1 was a particularly misleading measure of the public's readiness to spend. From December 1981 to December 1982, M1 increased 8½%—in large part because of the growth of such "other checkable deposits" as NOW accounts, which only recently were added to the M1 concept. Such deposits increased 34% during the year and came to account for over 20% of M1 balances. Under the old definition of money—currency



Quarterly Real GNP and Monthly GNP Proxy

Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

and demand deposits–M1 rose a relatively anemic 3½%. And weakness was even more conspicuous in the demand-deposit component, which grew only 1½%.

M1 became such an unreliable intermediate target for monetary policy because it came to reflect deposits with behavioral characteristics that were different from those of money in the old sense of the word. Based on debit records, demand deposits were "turning over" at an annual rate of about 340 at the end of last year. In effect, each dollar of demand deposits was supporting about $340 of transactions. The turnover rate for other checkable deposits at commercial banks, strikingly, was a small fraction of that–about fifteen. It was much closer to the turnover rate–about five–for savings deposits at commercial banks.

The change in the composition of M1 in 1982 seems to have been a major contributor to the extraordinary behavior of velocity–the ratio of nominal GNP to money (chart on page 9). The change in velocity between yearend 1981 and yearend 1982, in fact, was outside the range of historical experience. The pattern in M2 velocity also was atypical.

With velocity behavior so unusual, and with economic recovery in its infancy, it would be a great mistake for the Federal Reserve to revert to a strategy of responding mechanistically to monetary growth–a course urged by many monetarist economists. It could well mean a setback for the economy such as the one brought about by the Federal Reserve in the winter of 1981-82 as it responded to the rapid money growth of that period by allowing interest rates to back up until the middle of the year.

Since then, the Federal Reserve has pursued a strategy of flexibility. Significantly, the Administration is beginning to voice support for that approach. "Strictly speaking," the Council of Economic Advisers said in its annual report issued earlier this month, "inflexible monetary growth rates are appropriate only if the trend in income velocity is constant or has purely random disturbances. The advisability of a strict policy rule depends on the degree of predictability of velocity disturbances."

Flexibility on the part of the Federal Reserve is no guarantee that interest rates will be at levels that underwrite a normal recovery. Indeed, it is hard to see how those would come about in the all-important long-term markets. Fear of the preemptive nature of large federal borrowings for a long time to come is high and unlikely to diminish quickly. Nevertheless, a flexible strategy for monetary policy points to much less risk that recovery tendencies will be snuffed out once again.

Home-Equity Till-Tapping: No Surge Ahead

HOME owners cashed in heavily on the equity in their houses during the real estate boom of the late 1970s. Typically they did so by using only part of the proceeds of a home sale as the down payment on another house. Borrowings against home-owner equity, which reached a peak of $53 billion in 1979, became a convenient way to finance college tuition, a new car, or other major expenditure.*

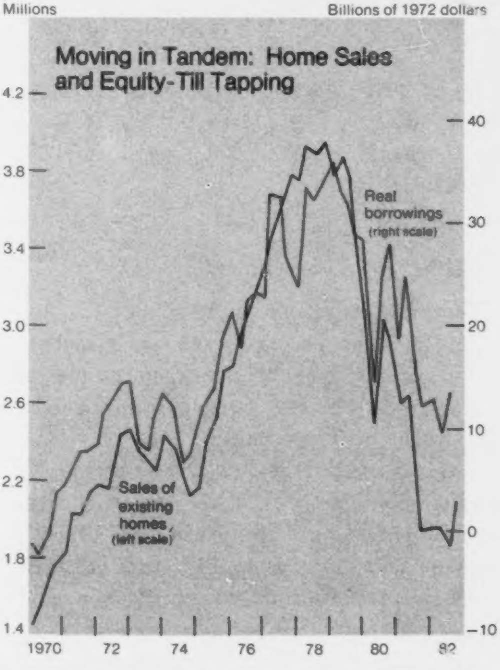
But don't expect home owners to resume this practice now that housing sales and starts are beginning to move up. A new housing climate —including changed attitudes toward housing as an investment—is working against a big rush to the home-equity till. Although this may dampen hopes for stronger consumer spending, it is probably good for housing construction and the general economy.

The role of home sales

One measure of borrowings against home-owner equity is the growth in mortgage debt outstanding in excess of amounts needed to finance the purchase of newly built houses. That measure, in constant 1972 dollars, has tracked the sales of existing homes closely—not only in the boom years of the late 1970s, but also in the bust that followed (chart on this page).

Surveys of home-purchase patterns conducted by the United States League of Savings Associations also point to a link between home sales and equity-till borrowings. On average, families that sold a house and bought another in 1981 (the last time a survey was taken) withdrew from their housing equity an estimated $20,900—the difference between an average down payment of $18,000 on the newly purchased house and average net proceeds of $38,900 from sale of the previous house. In 1979 borrowings against home-owner equity by repurchasers averaged $16,900—19% lower than the figure for 1981 but almost identical to it if the calculation is done in real terms.

Borrowings against home equity ran at an average annual rate of $12 billion, in 1972 dollars, in the first three quarters of last year —somewhat higher than could have been expected simply on the basis of the level of home sales (chart on this page). This probably reflects the active promotion of second mortgages or home-equity loans by banks and other lenders.



Note: Real borrowings plotted through third quarter of 1982, the latest period for which data are available.

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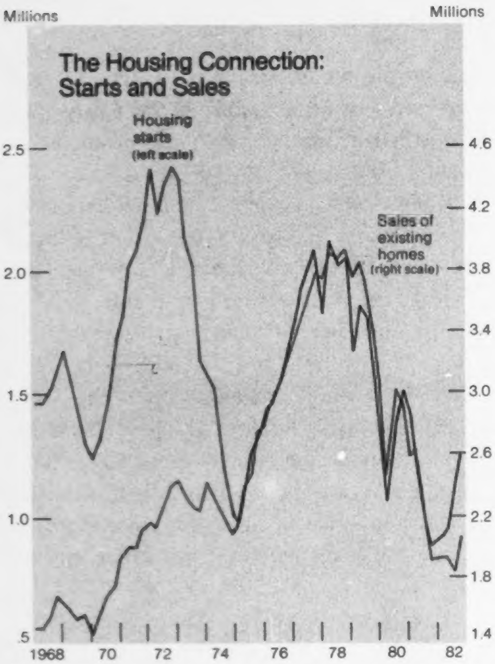
*"Tapping the Home-Equity Till," *The Morgan Guaranty Survey*, August 1979.



The Housing Connection: Starts and Sales

Still, in the near term, it is unlikely that home-equity loans will supplant buy-sell decisions as the main vehicle for cashing in on home equity.

Whither housing values?

A key consideration in the outlook for home sales is what people expect will happen to home prices. In the high-inflation years of the late 1970s, expectations of rising prices were of overwhelming importance.

Sales of existing homes, which averaged 2.1 million units annually in the first half of the 1970s, surged to record rates of nearly 4 million units per year in 1978 and 1979. Behind that rise was the widespread perception that housing was a smart investment in an age of high inflation. Price increases for houses (exceeding 15% per year by 1979) seemed to confirm the wisdom of a home purchase. Side by side with that perception was fear that delay in buying a house would mean being priced out of a market that seemingly had unlimited potential for gains.

Conditions today are strikingly different. During the past several years, prohibitively high mortgage rates have dramatically slowed the rise in home prices. On the basis of national averages for homes sold, prices have registered no increase to speak of over the past year. Moreover, the National Association of Realtors has estimated that the median price of homes sold in 1981 would have been 19% lower than reported if sellers had reduced prices by the cost to them of providing buyers with concessionary financing.

Trends in the resale market

If expectations of increases in housing values remain suppressed, a return to anything like the frenetic pace of housing turnover–and the associated equity-till borrowings–of the late 1970s is highly improbable. To be sure, sales of existing homes should begin to pick up in the next few months, reflecting the easing in mortgage market conditions that occurred in the second half of 1982. Already, some improvement seems to be under way, judging by realtors' estimates that sales this past quarter were running at an annual rate of almost 2.1 million units, up 12% from the third-quarter rate.

Improvement in the resale market, however, has not kept pace with the rise in sales of new homes and in housing starts in recent months. Without a return to the strong home-buying mood of the late 1970s, that may well continue to be the case. The pattern of the late 1960s and early 1970s is instructive. Relatively strong housing years, measured by new production, are entirely consistent with a turnover rate for existing homes that does not begin to approach the record pace of the late 1970s (chart on page 12).

Although tapping the home-equity till appears unlikely to provide greatly enlarged support for consumer spending, that may not be all bad. The frothy pattern in the late 1970s probably made the economy more unstable, more vulnerable to a setback. The real estate boom at that time, by spilling over into consumer markets, reinforced inflation. The subsequent tightening of mortgage credit intensified the weakness in consumer spending.

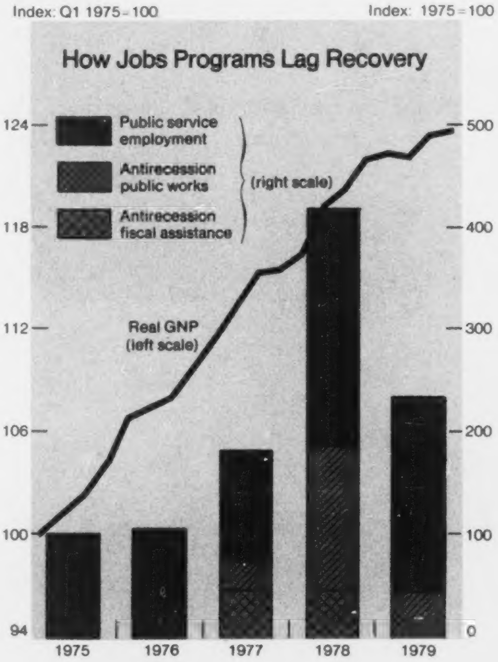
A change in the direction of a home-mortgage market that channels resources more to financing new production—and less to financing unusually high turnover rates—is also all to the good. Such a development would make it easier for the Federal Reserve to control overall credit growth—without at the same time hampering expansion of the nation's housing stock.

Misguided Efforts on Jobs

THE bipartisan push in Congress for a public-works jobs program reflects a growing concern for the plight of the unemployed. But a multibillion-dollar emergency effort probably is not the best way to help. Such efforts in the past usually were implemented long after they were needed, did little to employ the hard-core jobless, and proved difficult to terminate when recovery arrived and jobs opened up.

For example, the high unemployment rates during the 1974-75 recession and its aftermath prompted Congress to enact a trio of job-creating programs over a three year period—$2 billion for public works, $1¼ billion in antirecession aid for states and localities, and a special $6-billion temporary program to help the hard-core unemployed under the Comprehensive Employment and Training Act (CETA).

All three were slow getting started. It was not until mid-1978 that outlays reached their peak, almost three years after recovery had gotten under way (accompanying chart). The long lag between the trough of the recession and the policy response accentuated the cyclical



swing in economic activity—exacerbating inflation pressures in construction and related fields. Moreover, the beneficial effects on unemployment were quite limited, as was brought out in a 1979 study by the Office of Management and Budget.

It found that fewer than one in three hired for local public-works programs came from the ranks of the unemployed, and that wages paid these workers amounted to less than 7% of program costs. In addition, jobs for unskilled workers lasted, on average, less than four weeks.

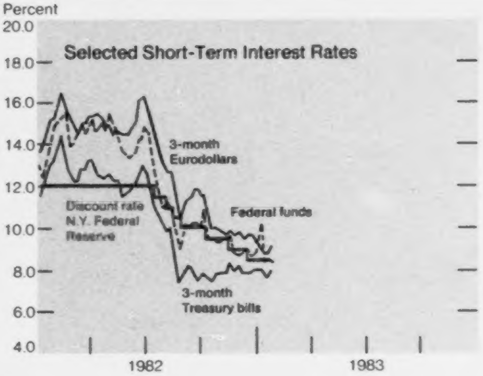
The effort to help the hard-core jobless under CETA proved somewhat more successful. Even so, only half those enrolled "graduated" to a new job, added training, or the armed forces. "Emergency" jobs programs in the aftermath of the 1974-75 recession, in short, did little to solve the nation's structural unemployment problem.

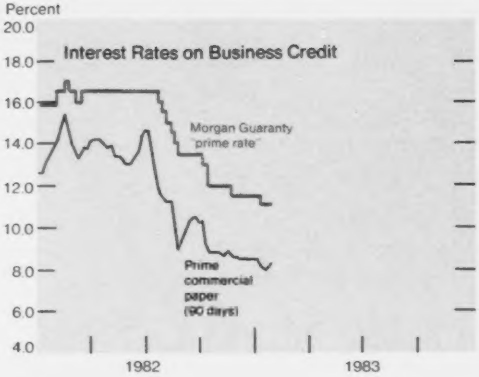
Disappointment with past efforts does not mean that new attempts to help the jobless should be avoided. The "Job Training Partnership Act" passed by Congress last October is a step in the right direction. It establishes a $620-million program for fiscal 1983 to prepare youth and unskilled adults for entry into the labor force and offers job training to the disadvantaged and hard-core unemployed. Training is to be provided at the local level, with private industry offering policy guidance and oversight.

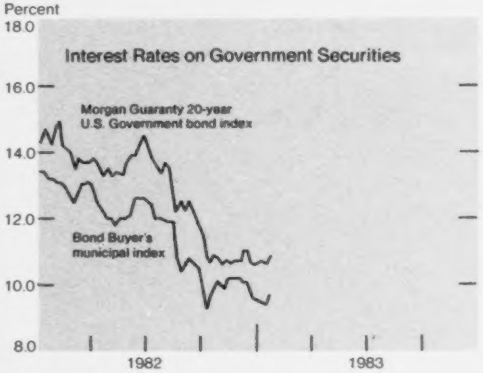
The President's new budget would expand that initiative. In all, President Reagan proposes to spend $3.5 billion on employment and job-training programs in fiscal 1984, down slightly from the current fiscal year. Even so, tightening up on administrative costs will mean that 2 million people will receive job training in the year ahead, compared with 1.8 million in the current year.

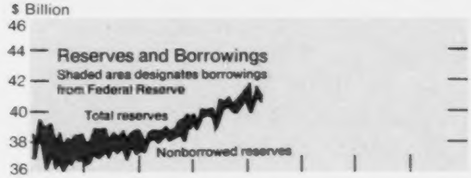
Job programs that provide training are a far better way to help the long-term unemployed than are well-meaning but ineffective emergency make-work programs.

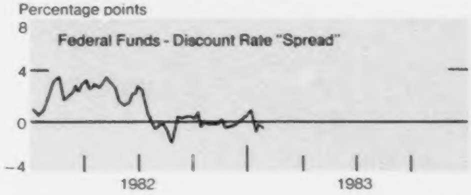
MONETARY INDICATORS

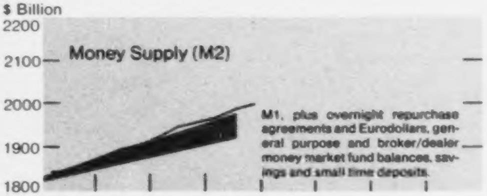


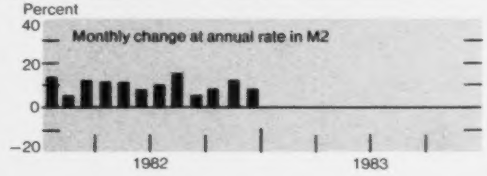


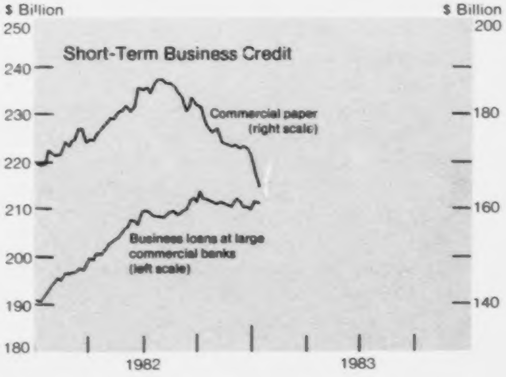












Note: Shaded area on the money supply chart represents the Federal Reserve growth target for the period from the fourth quarter 1981 to fourth quarter 1982. Business loans are net of bankers' acceptances. All data except interest rates and member bank borrowings are seasonally adjusted.

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Richer Households. *Consumer net worth is climbing—pushed up by gains in stocks, bonds, other assets. Will it lead to a spending boom? Analysis of household balance sheets cautions against expecting a major stimulus.* 1

Economy Watch. *Production is on the rebound as inventory drawdowns moderate. But a sustained rise hinges on a pickup in final sales. Latest projections, quarter by quarter.* 5

Jobless Pay. *The system is severely strained. High unemployment is draining the states, forcing heavy borrowing from the U.S. Treasury. Needed: a major overhaul?* 7

Pension Saver. *When a company fails, workers no longer lose pensions. A federal agency steps in to guarantee pension checks. But the agency's running into financial troubles of its own.* 12

The Significance of Rising Consumer Net Worth

THE value of consumer-held stocks, bonds, and liquid assets rose more than $500 billion in the last half of 1982. That gain, coupled with small increases in other assets, has materially strengthened household balance sheets.

Many analysts believe this will soon translate into a substantial strengthening of consumer buying. But a close look behind the numbers suggests a much more cautious forecast.

Changes in household net worth arise from two sources. One source is personal saving, which is invested in, say, stocks or bonds or in tangible assets such as houses—less, of course, any debt incurred to acquire the assets. The second is capital gains or losses on those assets.

Recently, the gains in net worth have been concentrated in a few asset categories.

Long-term debt instruments. Government and corporate bond prices rose an average of about 20% in the last half of 1982, increasing the value of households' long-term asset holdings. Further acquisitions, along with those capital gains, added some $150 billion to this component of household net worth by yearend (table on page 2).

Corporate equities. Consumers have been net sellers of corporate equities since the mid-1960s. Nonetheless, their holdings (including those in retirement funds) were large enough to generate about $374 billion in capital gains during last year's second half.

Liquid assets. Holdings of cash and other immediately available funds rose by some $75 billion in the last half of 1982. Despite the buildup, however, the percentage gain in liquid assets in all of 1982 was smaller than any since

Gains in Household Net Worth

(Market value in billions of dollars, end of period)

	1981	*1982 Q2*	*1982 Q4*	*1982 Gain: Q4 over Q2*
Long-term debt assets	390	429	579	150
Corporate equities	1,380	1,222	1,596	374
Liquid assets	2,036	2,126	2,201	75
Other financial assets	1,104	1,122	1,218	96
Total financial assets	4,910	4,898	5,594	696
Housing and land	2,978	3,066	3,142	76
Other assets	3,043	3,118	3,185	67
Total assets	**10,931**	**11,083**	**11,921**	**838**
Liabilities	**1,529**	**1,571**	**1,680**	**109**
Net worth	**9,402**	**9,512**	**10,241**	**729**
Real net worth*	**3,330**	**3,280**	**3,491**	**211**

*Billions of 1967-69 dollars.

the 1969-70 recession, reflecting lower inflation and the weak economy.

Other assets. Tangible assets, such as housing and autos, equity in individually owned businesses, and pension and life insurance reserves rose a modest $239 billion—or 3.3%—in 1982's second half. Even though consumers stepped up their acquisition of houses and durable goods toward year's end, the percentage gain in the value of other assets in all of 1982 was the smallest annual increase in more than 16 years.

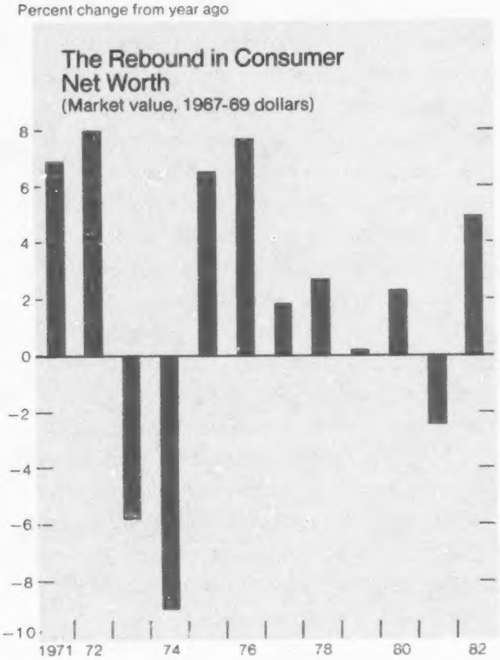
Total assets. All told, household assets, adjusted for increases in market value, grew an estimated $838 billion in the second half of 1982. Two-thirds of that rise was concentrated in bonds, equities, mortgages, and liquid assets. By contrast, growth in such assets made up less than half the increase in total household assets during the six-month period before the trough of the 1973-75 recession.

To arrive at consumer net worth, assets must be reduced by liabilities. And liabilities need to be adjusted for changes in market value.

The rise in the market value of liabilities in the last six months of 1982, estimated at $109 billion, resulted in a second-half increase in net worth of $729 billion. When adjusted for the rise in consumer prices, the second-half rise in net worth comes to 6.4%. Because real net worth actually declined 1.5% in the first half of the year, the increase for all of 1982 was 4.8%. That was only about two-thirds as large as the gains recorded in 1975 and 1976 (chart at top of page 3). A major reason for the smaller rise, as seen in the other chart on page 3, is that earlier sharp gains in housing net worth fizzled out in 1982.

Spending impact

Though the rise is smaller than in periods before past recoveries, enlarged net worth will contribute to increased consumer spending. The key question: How big an influence will it be? Quantification has been attempted in the voluminous body of research into factors affecting personal consumption. Consumer outlays, the research shows, are influenced primarily by the trend in after-tax personal income. Net worth plays only a secondary role. Households save and hold wealth to provide income for retirement, for an estate for their children, and as a cushion against interruption of income. As a result, it is likely that only a small portion of rising net worth will go for consumption. To be sure, there may well be a psychological "wealth effect" that will spur consumption. Even so, the fact that net worth has risen recently is not likely to provide a major lift for consumer outlays,



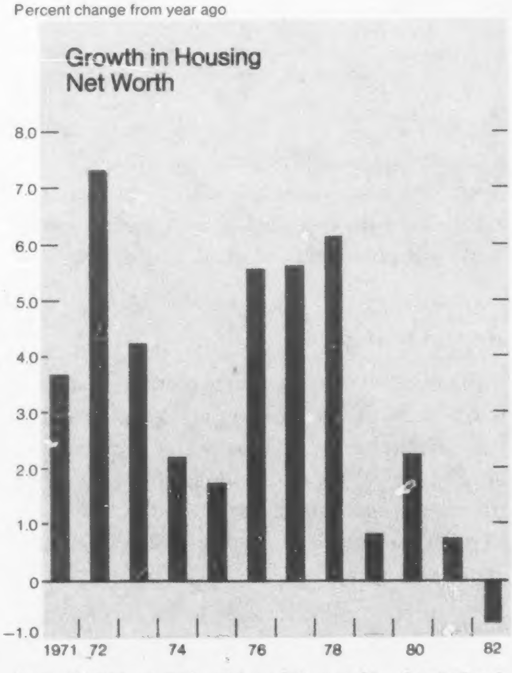
particularly because household net worth was weak during the five years before mid-1982.

Several studies in the post-World-War II period have measured the differing effects of the components of income and wealth on consumption.* These studies, which are confirmed by Morgan Bank analysis, indicate that the impact on spending of enlarged net worth will be small —and spread out over time.

The analysis suggests that, for each $1 rise in the real value of equities that was sustained for 18 months, real consumption expenditures can be expected to go up only four cents. Two factors condition this modest effect: the realization among consumers that stock market gains may be transitory, and the illiquid nature of the 15% of equity assets held by retirement funds for households.

Gains in other types of wealth show larger —though still modest—effects on spending. A $1 rise (adjusted for inflation) in financial assets such as bond holdings, bank deposits, or mortgage investments seems likely to raise consumption outlays by about nine cents over a three-year period. Finally, a $1 increase in the real value of tangible assets will raise consumption by about eight cents within three months.

Over the last half of 1982, real personal consumption outlays rose a modest $12.5 billion



Note: Housing net worth equals market value of housing stock and land owned by households less value of mortgages outstanding, expressed in dollars of 1967-69 purchasing power.

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*The pathbreaking work is summarized in Albert Ando and Franco Modigliani, "The Life-Cycle Hypothesis of Saving: Aggregate Implications and Test," *American Economic Review*, 53 (March 1963) 55-84. More recently, a refined analysis was contained in *Quarterly Econometric Model*, Board of Governors of the Federal Reserve System, November 1982. Estimates made by The Morgan Bank build on those in the latter study.

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Contributions of Income and Net Worth to Consumption

(Billions of 1972 dollars at annual rate)

	Change from 1982 Q2 to 1982 Q4
Increase in consumption	12.5
Due to Q2-Q4 1982 changes in:	
Labor income	1.4
Property income	1.2
Transfers	8.2
Value of equities	1.6
Value of all other financial assets less liabilities	.3
Value of tangible assets	.1
Influences due to earlier changes	−.3

Note: Income is measured after tax. Property income includes rent, net interest, dividends, and proprietors' profits. Transfers are mainly Social Security payments and unemployment compensation.

at an annual rate. The table on this page–derived from historical relationships–shows rough estimates of the contribution of various components of income and net worth to that rise.

Recent trends

Significantly, the estimates indicate that two-thirds of the rise in consumption reflected higher transfer payments, such as Social Security and unemployment compensation. Income gains from wages and salaries, weakened by the recession, made only a modest contribution to increased consumption.

The estimated combined "wealth" stimulus to consumption from the second quarter of 1982 to the final quarter amounted to about $2 billion (lines five, six, and seven of table), with rising equity values the largest contributor. As noted earlier, the estimated effect on consumption of a dollar's rise in real equity values is small. But the recent increase in real equity values was sufficiently large to have a disproportionate impact on consumer outlays. The estimated contribution from gains in other financial assets was negligible–reflecting their small rise. Similarly, tangible assets contributed only marginally to consumer outlays.

The composition of these contributions to enlarged consumer spending will probably change substantially during 1983. The stock and bond markets may well improve further, but not at the breathtaking pace recorded in the last six months of 1982. Reversing recent declines, house prices are already firming–though housing analysts see no boom in prospect comparable to the spectacular rises of the 1970s.

All in all, gains in household net worth will likely contribute modestly to higher spending. In The Morgan Bank's projection, additional consumption attributable to improved consumer net worth is expected to amount to some $4 billion. That would account for only 12% of the projected $34-billion rise in real consumption spending during 1983.

The major conditioner of consumer outlays this year will be the uptrend in personal income. And that uptrend is likely to be sluggish in comparison with past recoveries. As a result, the consumer, despite improved net worth, seems likely to remain cautious in the year ahead.

Economy Watch

ECONOMIC prospects have brightened in the past two months. Though measuring the improvement is complicated by weather–unusually mild in January, violently stormy in many parts of the nation in February–the underlying trend for output seems to be on the rise. Weakening oil-product prices, meanwhile, have reinforced the positive outlook for reduced inflation.

The turnaround in labor markets has been particularly heartening. On average, for example, January and February readings for employment in the private sector rose at an annual rate of almost 1% over the fourth-quarter average. While surely not a major improvement, the gains nevertheless were a welcome contrast with the previous pattern of sharp decline.

In contrast to signs of strengthening in output-related measures, final sales seem only to be inching up this quarter. Though auto sales moved sharply higher at the end of last year, they have not made progress since. This is especially disappointing considering the relatively attractive financing terms still being offered. Nonauto sales at retail have traced a similarly weak pattern–rising negligibly in the past four months. Lower oil-product prices explain some of the weakness in the dollar volume of such sales. Even so, the pattern has been one of only very moderate improvement. While housing activity has advanced smartly in the past few months, this has just offset the continuing decline in business investment. All in all, real final sales appear to have increased at an annual rate of only 1.4% this quarter. To be sure, part of the slow growth is due to a decline in federal purchases of farm commodities. Even excluding this factor, however, final-sales growth has not been strong enough to keep orders and output rising at anything like their recent pace.

The Morgan Bank now forecasts an increase in real GNP this quarter of 4.7% at an annual rate (table on next page), compared with 3.8% forecast last month. Only about three-tenths of the increase is attributable to growth in final sales; the rest, to an inventory swing. The record rate of inventory drawdown in the fourth quarter of last year set the stage for a significant rise in output. Business needed to restore a better balance between production and sales volumes. This was particularly true for producers of autos and trucks–output of which, despite the lack of momentum in sales, is advancing at an estimated annual rate of 50%

LAGGING TAX REFUNDS

RECENT Treasury data raise some question as to whether individual tax refunds are going to be as much of a bolstering influence on consumption this spring as some analysts have been suggesting. Strikingly, personal tax refunds through early March ran about $1 billion below the level a year earlier. Some of this shortfall may be due to processing delays. These, however, should not affect the size of refunds–and the average size, surprisingly, is running below last year. Interest income during 1982, which swelled tax liabilities of individuals–but on which there was no withholding–may be one explanation.

To be sure, the refund pace is likely to accelerate between now and June because of a probable "bunching" of deductions for Individual Retirement Accounts. But current data show a definite sluggishness in refunds–suggesting that refunds are likely to rise something like $10 billion in 1983. Refund estimates by some analysts have ranged as high as $25 billion.

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1982	1983			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−1.9	4.7	3.3	4.7	5.3
Real consumer spending	4.8	2.6	3.6	3.8	4.2
Real business-capital outlays	−8.1	−9.8	2.2	3.6	5.4
GNP deflator	3.7	3.7	5.8	4.1	4.5
Consumer prices	2.0	0.4	4.3	5.0	5.1
Real disposable personal income	0.9	1.5	2.5	5.6	4.3
Saving rate (%)	6.1	5.8	5.6	6.1	6.1
Housing starts (Millions)	1.3	1.5	1.6	1.7	1.7
Auto sales (Millions)	8.7	8.6	8.8	9.2	9.5
Unemployment rate (%)	10.7	10.5	10.6	10.7	10.6

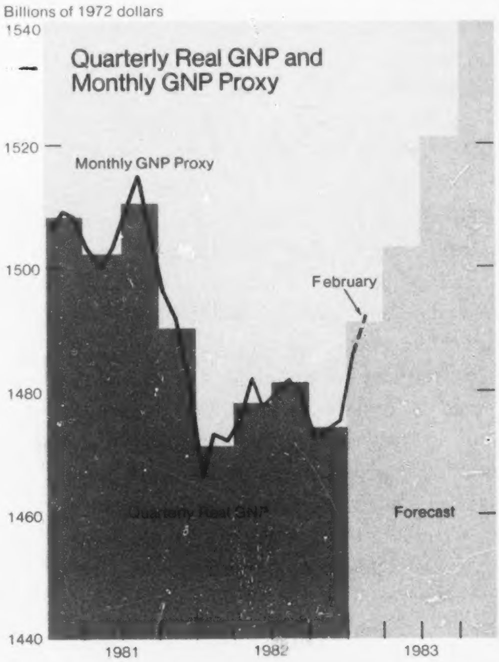
Note: 1982 Q4 data are actual.

this quarter. That increase alone accounts for about 1½ percentage points of the estimated growth of GNP this quarter.

Needed: a pickup in sales

If recent gains in output are to last, final sales will have to pick up. This seems likely to happen during the spring. For one thing, the rebound in output now coming from the swing in inventories should be reflected in comparatively strong gains in payrolls. And effective purchasing power will be enhanced by declining oil prices. As a result, the pace of consumer spending should quicken. At the same time, the drag on final sales now being exerted by declining investment spending should end—given the improvement in capital-goods orders of recent months.

These positive developments seem likely, but they cannot be taken for granted. At the moment, lackluster final sales must be considered a potential constraint on the vigor of the recovery during the next few months. Confirmation of improved sales is needed to justify an unqualified assertion that a solid cyclical upswing is under way.



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

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Jobless Pay: Strains in the System

THE nation's unemployment insurance system is coming under growing pressure. With jobless benefits now running at a $30-billion annual pace, many states have used up funds for the program and must rely on borrowing from the United States Treasury, adding to strains on the federal budget. At the same time, almost half of the nation's unemployed are drawing no benefits because they have exhausted them or are ineligible.

Many analysts believe that the insurance system is simply unable to cope with today's most pressing problem: protracted unemployment.* Whether the present system—basic state programs supplemented by federal efforts—needs to be overhauled seems likely to get attention as Congress focuses increasingly on problems of the unemployed.

The unemployment insurance system has a long history and complex underpinnings. Established in 1935 under provisions of the Social Security Act, it was intended to provide a temporary, modest flow of income while at the same time cushioning the economy against the impact of lost wages. About 90% of the civilian labor force, including 97% of all wage and salary workers, is covered. Those not covered include some farm workers, the self-employed, and some domestic household workers.

Each state establishes its own rules for eligibility and benefits and imposes taxes to finance the program.** The federal government acts as a depository for federal and state unemployment insurance taxes. In addition, with the federal share of unemployment taxes it funds administrative costs of the system, participates directly in an extended benefits plan, and monitors state programs.

Taxes and benefits

Payroll taxes are levied on employers both at the federal and state levels.* The federal tax is 3.5% applied to the first $7,000 of wages per worker. Effectively, however, the federal tax is much lower since firms can offset up to 2.7 percentage points by claiming credits for state jobless taxes. (The net amount, typically 0.8%, is earmarked by the federal government to fund its responsibilities to the system.) Locally, tax rates vary significantly from state to state and among employers. After establishing a tax rate schedule, most states determine the actual rate paid by individual employers based on their unemployment record.

Profile of the Unemployed, January 1983

(Millions of persons, not seasonally adjusted)

Total unemployed	12.5
Drawing jobless benefits	6.5
State programs	4.9
Federal supplemental compensation	1.1
Extended benefits	.4
Other	.1
Not drawing benefits	6.0

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*In January, 5 million people had been out of work for at least 15 weeks. More than half of them had been jobless for over six months.

**Puerto Rico, the Virgin Islands, and the District of Columbia also participate. In addition, separate, self-contained programs, maintained and financed by the federal government and the railroads, protect newly discharged veterans, federal employees, and railroad workers.

*A few states (Alabama, Alaska, and New Jersey) also tax workers.

A firm with a light history of layoffs usually would be taxed at a lower rate than would one with a heavier record.

The maximum duration of benefits available under regular state programs is 26 weeks in most states. However, the actual period during which a claimant may draw benefits—and the amount of compensation—is calculated on the basis of the worker's wage and employment record. In order to establish benefit eligibility, claimants generally must have lost their jobs through no fault of their own and must be able to accept and be actively seeking suitable employment. The claimant must also have satisfied minimum guidelines for work experience and earnings in a base period. Such guidelines differ widely across the country.

Payments also vary significantly, as is illustrated in the table of benefits on page 9. In general, benefits are some fraction of a claimant's weekly wages—usually less than 50% of lost wages—up to stipulated ceiling amounts. While potential maximum weekly benefits in 1982 ranged from a low of $84 in Puerto Rico to a high of $234 in Massachusetts, average actual payments were much smaller: as little as $64 in Puerto Rico and as much as $154 in Michigan. Weekly benefits nationwide averaged $119, approximating the after-tax earnings of a wage earner paid the minimum wage for a 40-hour week.*

An extended benefits program, financed jointly by the federal government and participating states out of employer payroll taxes, provides up to 13 weeks of additional coverage at the same rate of compensation available under regular state programs. Complex formulas trigger the extended benefits program.*

Responding to the sharp deterioration in job markets during the latest recession, Congress added an emergency program—Federal Supplemental Compensation (FSC). Financed entirely by the federal government out of general revenues, it provides up to 16 additional weeks of benefits. FSC has been in effect since last September and was to have expired in March. However, President Reagan has proposed that the program be extended (as well as modified to include tax incentives for firms that hire FSC recipients).

If an unemployed worker were eligible to participate fully in state, extended benefits, and FSC facilities, jobless benefits might conceivably be drawn for as long as 55 weeks. In practice, however, participation is typically of much shorter duration either because a beneficiary has limited eligibility or because the claimant finds another job. For example, participation under regular state programs has averaged about 12 to 16 weeks over the past 10 years.

Gauging performance

The effectiveness of the unemployment insurance system can be measured in three ways:

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*Jobless benefits, in general, are not taxable. However, the Revenue Act of 1978 provided for taxation of as much as one-half of unemployment compensation if a beneficiary's adjusted gross income from jobless benefits and all other sources exceeded $20,000 ($25,000 for married taxpayers filing jointly). The Tax Equity and Fiscal Responsibility Act of 1982 lowered the threshold for taxation to $12,000 for single taxpayers ($18,000 for married couples).

*The extended benefits facility generally is activated in a state when, over a 13-week period, its insured unemployment rate (the number of insured claimants for regular state unemployment benefits as a percent of all covered workers) exceeds the average percent for comparable periods in the two preceding years by 20% or more. Additionally, the state's insured unemployment rate must be at least 5% (recently raised from 4%). State law may also provide for waiving the 20% triggering rule if the insured unemployment rate is at least 6% (recently increased from 5%). Once extended benefits are triggered, benefits are payable for 13 weeks. The facility must then remain off for 13 weeks before it can be reactivated.

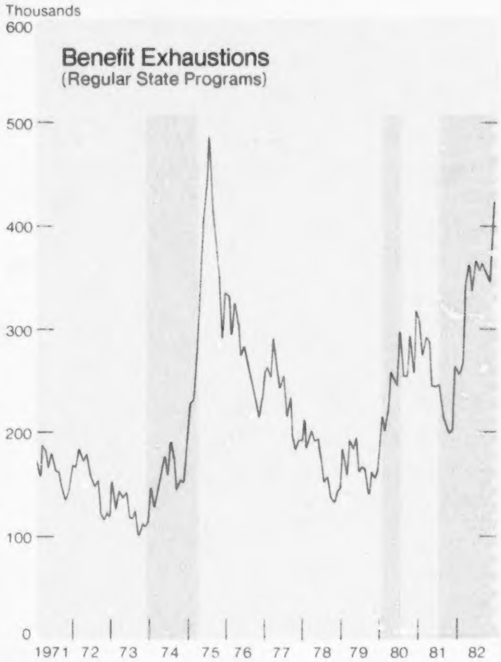
Jobless Benefits

	Average weekly dollar benefits in 1982	*Percent of average gross wages replaced in 1981**		*Average weekly dollar benefits in 1982*	*Percent of average gross wages replaced in 1981**
United States	**119**	**35.9**	Montana	122	41.4
Alabama	80	28.8	Nebraska	97	36.8
Alaska	130	26.9	Nevada	116	35.9
Arizona	100	29.7	New Hampshire	95	33.3
Arkansas	96	37.4	New Jersey	115	32.9
California	100	28.5	New Mexico	105	32.6
Colorado	141	39.1	New York	99	28.1
Connecticut	120	34.5	North Carolina	104	36.5
Delaware	98	32.0	North Dakota	128	42.3
District of Columbia	141	37.8	Ohio	144	39.4
Florida	95	30.4	Oklahoma	137	37.3
Georgia	96	30.2	Oregon	117	36.0
Hawaii	130	44.8	Pennsylvania	146	41.8
Idaho	116	38.7	Puerto Rico	64	33.3
Illinois	146	40.1	Rhode Island	108	38.8
Indiana	94	28.5	South Carolina	94	33.7
Iowa	137	43.7	South Dakota	110	45.0
Kansas	128	39.9	Tennessee	87	30.8
Kentucky	116	36.7	Texas	127	31.6
Louisiana	145	38.0	Utah	130	39.6
Maine	101	38.3	Vermont	107	38.6
Maryland	116	33.4	Virginia	108	36.5
Massachusetts	115	36.0	Virgin Islands	87	30.0
Michigan	154	35.2	Washington	131	36.1
Minnesota	137	42.5	West Virginia	130	34.9
Mississippi	80	30.1	Wisconsin	137	42.6
Missouri	94	31.3	Wyoming	137	35.4

*Latest year available.

its success as a built-in stabilizer; its performance as a source of assistance to jobless workers; and its fundamental fiscal soundness.

Economic stabilizer. The system is helping to stabilize the personal income stream of the economy. Total unemployment benefits provided almost $25 billion of personal income in 1982, as compared with average jobless out-



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open.

Source: U.S. Department of Labor

lays of $11½ billion in the preceding 10 years. Private sector wages increased last year by only 3.9%, or $47 billion, while unemployment compensation outlays rose by 62%, or $9.5 billion.

Income maintenance. The jobless pay program was designed to replace a portion of wages lost. The aim was to make it possible for people to maintain a basic standard of living until they could find new jobs. The Labor Department estimates that in 1981 average weekly benefits replaced just over one-third of average gross wages lost, approximating the experience of the preceding 10 years.

Significantly, however, the system's inability to protect the jobless in cases of protracted unemployment became dramatically evident in 1982 when there was a sharp rise in the number of individuals newly exhausting state benefits (chart on this page). When the jobless run out of benefits under all other programs, they can turn to the emergency FSC facility. Even so, about 6 million unemployed face hardships for lack of any government jobless pay. To be sure, such hardships can vary. For example, a sole breadwinner with a family can find it more difficult to cope than would, say, a man or woman whose spouse is employed or a teenager able to rely on working parents. Still, the many unprotected jobless reinforce the impression that the unemployment compensation system is not equipped financially to handle massive and protracted unemployment.

Fiscal integrity. The system was designed to be self-financing. It was expected that during economic expansions the inflow from payroll taxes would exceed benefit payments, permitting reserves to accumulate in unemployment insurance trust funds. Reserves built up in prosperous times, it was assumed, would be available in sufficient amounts to fund large, countercyclical payouts in recessionary periods when outlays might exceed tax inflows. It has not worked that way in recent years. Financial integrity of the state system has deteriorated.

State trust funds have been drained by mounting claims during three recessions and intervals of stagnation over the past decade. Many states have been unable to replenish their reserves during recovery periods. As a consequence, almost half of the states have had to borrow from the Treasury to finance their programs.

In 1982 alone borrowings by states amounted to $5.2 billion, more than triple the amount of borrowings in 1981 (chart on page 11). By year-end 1982 the trust funds of 20 states (plus the District of Columbia, Puerto Rico, and the

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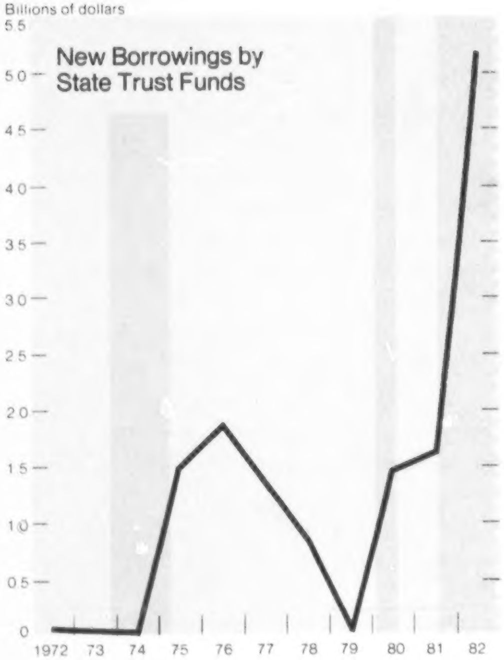
Virgin Islands) were operating in the red and several other states had applied for loans. A record $10.6 billion of state loans was outstanding, including $1 billion added in December 1982 alone.* Prior to the mid-Seventies, only three states had gone into debt.

The Extended Unemployment Compensation Account, which supplies the federal share of extended benefits, also has $6.8 billion of loans outstanding. Thus, the combined debt of the unemployment insurance system (virtually all of which is owed to the Treasury) totaled a record $17.4 billion at the end of 1982—and is still rising.

What makes the system's financial plight even more discouraging is the prospect of continued double-digit unemployment for months to come—suggesting further shortfalls of payroll tax receipts relative to benefit outlays.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open.

Source: U.S. Department of Labor.

The larger problem

Continuing high levels of unemployment presage further depletion of state trust funds and mounting debt. Only a return to broad economic expansion and significantly lower unemployment can lighten the load in any major way.

That is not to say, however, that states need take no action. A close look at the financial underpinnings of the system—particularly taxes in relation to benefit costs—is becoming a necessity. Some states already are moving in that direction. Michigan, for example, has just raised its payroll taxes and trimmed benefit payments.

Even with a return to fiscal soundness at the local level, however, state programs—designed to provide short-term help—would not be in a position to accommodate prolonged and massive unemployment. The emergency program of jobless benefits under federal auspices—the FSC—recognizes that reality.

While such programs help to ease the hardships associated with long-term joblessness, they do not root out the essential cause. In the final analysis, what is needed is a national focus on policies that will facilitate sustained, noninflationary economic growth accompanied by a revitalization of labor markets. To the extent that renewed prosperity restored financial strength to the system, there might be less need for added taxes—a welcome development for companies already laboring under heavy overall business costs.

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*In the past, federal loans to state trust funds were interest free, providing no special incentive for early repayment. Starting April 1, 1982, however, interest charges of approximately 10% have applied to new loans.

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Pension Guarantees: How Well Are They Working?

IN 1964 Studebaker stunned employees by closing its South Bend, Indiana, auto plant and terminating its pension plan. Because the plan's assets were insufficient to cover participants' claims, only those workers aged 60 or over received full benefits. Thousands of others got a small fraction of what had been promised–or nothing.

That shocker was a main factor behind the creation of the Pension Benefit Guaranty Corporation (PBGC), a federal agency intended to protect employees from similar losses. Since it was established in 1974, PBGC has stepped in to insure that all participants receive a portion of their vested benefits, up to stated limits, when firms have folded plans without enough assets to cover claims. About 28 million workers and retirees enrolled in single-employer plans* are covered by PBGC–a number roughly equivalent to one-third of the employees on private nonfarm payrolls.

Until recently, PBGC has gone to the rescue mainly of plans that were quite small. Reflecting this, fewer than 55,000 beneficiaries received pension payments, totaling less than $100 million, from the agency in 1982. With bankruptcies at a post-Depression high in the past year or so, however, some larger firms have folded inadequately funded plans. White Motor Company and Braniff Airways, Inc., are two of the more prominent examples. A few firms, moreover, have taken advantage of a loophole that lets a company end an underfunded plan and still continue in business.

While PBGC has coped so far with all the plan terminations, the agency is running into financial troubles of its own. It does not face an imminent cash crisis, because by drawing on accumulated assets it will be able to meet all current benefit payments for several years. But the agency's assets are inadequate to meet its known obligations farther down the road.

Moves are afoot to improve PBGC's ability to handle its responsibilities. They would not, however, assure that the agency could cope if it were hit with an unusually large plan. Some steps proposed by PBGC, moreover, have met resistance in the business community.

PBGC was created as a self-financing agency by the Employee Retirement Income Security Act of 1974 (ERISA). It insures, up to stated limits, the vested (or nonforfeitable) benefits of participants in defined-benefit plans–that is, plans providing a stated pension, usually based on pay and/or years of service. The insurance covers, on average, 85% of vested benefits. The maximum benefit insured, adjusted annually to reflect increases in the Social Security wage base, rose from $750 a month in 1974 to $1,381 in 1982. This year the maximum is $1,517 a month.

Participation in the insurance program is mandatory for virtually all companies having defined-benefit plans. Of the 33,000 such plans that were terminated between 1974 and 1981, about 3% did not have enough assets to cover insured benefits. In such cases PBGC takes over both the assets and the liabilities of the plan

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*Single-employer plans are those set up by individual firms for their own employees. PBGC also guarantees benefits of some 8 million people belonging to multiemployer plans, which are sponsored by two or more firms (usually in the same industry) and cover workers in all the sponsoring firms. Because of concern that the original PBGC program would encourage termination of multiemployer plans, Congress postponed full coverage of such plans to allow for revisions in the program. Revised rules, established by the Multiemployer Pension Plan Amendments Act, took effect September 26, 1980. The multiemployer program, which differs in major respects from the single-employer program, is not discussed in this article.

Claims on Pension Benefit Guaranty Corporation

(Dollar figures in millions)

Fiscal year	*No. of plans*	*Guaranteed benefit liabilities*	*less*	*Plan assets*	*less*	*Employer liability*	*equals*	*Net claims*
1975	98	58.9		18.8		5.6		34.5
1976	172	87.1		43.4		27.9		15.7
1977	136	52.9		21.5		6.9		24.5
1978	99	125.3		44.5		7.0		73.9
1979	79	88.2		35.3		4.6		48.4
1980	97	138.6		65.0		2.9		70.7
1981	102	129.4		46.8		5.2		77.3
Total	783	680.4		275.3		60.1		345.0

Note: Single-employer plans only.

and becomes responsible for paying guaranteed benefits. On termination of a plan, employer contributions cease, as do employees' vesting and accrual of benefits. To help offset the plan's underfunding, PBGC can claim up to 30% of the employer's net worth (what is left after a firm's liabilities are deducted from its assets). In bankruptcies, however, there often is little net worth for PBGC to claim. In terminations by firms that stay in business, unfunded liabilities often exceed 30% of net worth.

Benefits not covered by plan assets and 30% of the employer's net worth (the employer's liability payment) are met with premiums paid by firms whose plans are insured by PBGC. Premiums are the same for all plans and are set by Congress. Initially $1 a year per participant, premiums were raised to $2.60 in January 1978. In addition, PBGC may borrow up to $100 million from the Treasury to finance its operations. This is the extent of the federal government's responsibility for the insurance program.

From PBGC's inception through fiscal 1981, the agency assumed guaranteed benefit liabilities of 783 terminated plans totaling $680 million.* Of this sum, $275 million was covered by plan assets and $60 million by employer liability payments, leaving net claims on the agency of $345 million (accompanying table). As the table shows, 1981 brought the highest total of net claims recorded in any one year—$77 million.

In 1982, with Braniff and some other large cases coming in, the agency's experience was worse. Though final figures for the year (ended September 30) are not yet available, some officials have said that net claims may exceed $200 million.

The agency's pre-1982 accumulation of net claims, to a total of $345 million, overstates its financial problem. The reason is that the total has been offset in part by premium payments, investment income, and a reduction in claims as some benefits have been paid off. Even so, PBGC wound up fiscal 1981 with an asset deficiency of $189 million (table on this page). That deficiency–or accumulated deficit–represents the gap between the agency's current assets and the present value of the future benefits it is obligated to pay.* Figures for 1982 are expected to show an accumulated asset deficiency of about $300 million.

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*$680 million is the sum of the present value of each plan's guaranteed benefit liabilities calculated using PBGC interest rate assumptions for valuing benefits in effect on each plan's date of termination.

Faced with forecasts of growing deficiencies, PBGC asked Congress last year to raise premiums to $6 a year per participant from the current $2.60. The requested increase was based on estimates that a $6 premium would put the insurance program on a fully funded basis within five years, assuming that experience continued more or less in line with that of previous years. Many companies have questioned the need for PBGC to have such a large increase, with one group of plan sponsors suggesting that a $4 premium probably would meet the agency's needs.

Whatever premium increase is ultimately granted, plan sponsors want it tied to plugging the loophole that lets a company hand its unfunded liabilities to PBGC and still continue in business. Under the law, a firm can do this by paying up to 30% of its net worth to the agency. For firms with low net worth and large unfunded liabilities, this can be an attractive option. But it is widely viewed as inequitable, because it forces other companies to shoulder pension promises abandoned by companies that remain in business.

PBGC Income Statement

(Fiscal years; millions of dollars)

	1980	*1981*
Revenues	93.4	69.6
Premium income	71.2	75.0
Investment and other income	22.3	(5.4)
Expenses	41.6	163.8
Losses on terminated plans and plans pending termination	26.3	140.6
Administrative expenses	19.8	20.6
Actuarial adjustments	(4.4)	2.5
Balance	51.8	(94.2)
Memorandum item:		
Asset deficiency at beginning of period	(146.4)	(94.6)
Asset deficiency at end of period	(94.6)	(188.8)

Note: Single-employer program. Totals may not add due to rounding.

Only a handful of firms have used this loophole, most of them in the past year or so. But they represent a substantial drain on the agency. PBGC estimates that plan terminations by ongoing firms may account for as much as half of the dollar amount of claims in 1982.

A study published a year ago by Alicia H. Munnell, vice president and economist of the Federal Reserve Bank of Boston, quantified the potential dumping problem.* In screening 1980 data for 6,000 firms, the author identified 86 companies with unfunded liabilities exceeding 30% of net worth. Together, they represented a potential claim on PBGC totaling $4.3 billion, after deduction of employer liability payments. From the group of 86 the author singled out 22 "financially burdened" firms with the greatest incentive to terminate, as measured by the ratio of unfunded liability to 30% of net worth. This group had a potential claim on PBGC exceeding $3 billion.

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*In figuring the asset deficiency, or accumulated deficit, PBGC values assets on a basis that takes into account fair market value. The present value of guaranteed future benefits is computed using certain actuarial assumptions, the most important of which is the assumed rate of interest used to discount future benefits. In calculating its fiscal 1981 deficit, PBGC assumed an interest rate of 10.25% for valuing immediate annuities (those being paid to retirees or due to be paid shortly) and reduced rates for valuing deferred annuities.

*"Guaranteeing Private Pension Benefits: A Potentially Expensive Business," *New England Economic Review*, March/April 1982.

This list, prophetically, was headed by Rath Packing, an ongoing Iowa firm that, according to PBGC, ended its plan last autumn with an asset insufficiency of some $40 million. The list also included two major firms, each with a potential claim of nearly $1 billion. Should a "couple of large companies" such as these terminate their plans, Ms. Munnell stated, the yearly premium required to cover their unfunded obligations would approach $20 per participant—nearly eight times the premium now paid by insured companies.

Protective moves

To head off potential problems, PBGC has proposed that it take over inadequately funded plans only on liquidation of their sponsors. That approach has won backing from most employers. Though details have yet to be worked out, the proposal envisions that if firms meet certain tests of hardship PBGC still would step in. Otherwise a firm could cease to credit further service, but it would have to fund existing liabilities as long as it stayed in business.

A problem akin to the dumping of pension plans on PBGC can arise when a firm sells or "spins off" a subsidiary having large unfunded liabilities. If the acquirer or new unit has little net worth and later ends the plan, PBGC winds up holding the bag. Some cases of this kind have prompted the agency to propose that the original sponsor be held contingently liable for the detached unit's plan for up to 15 years. Many firms, objecting that this would unduly complicate business transactions, propose instead that the selling company's liability be phased out over five years.

PBGC also has sought to change its status as a claimant in bankruptcy actions to that of a general creditor. The reason is that, with general-creditor status, the agency would participate in the division of assets of a firm being liquidated. That proposal, however, was opposed by many plan sponsors, in part because of concern that it could impair access to bank credit for many firms with unfunded liabilities.

It needs to be emphasized that the steps being most widely discussed do not get at the problems that would confront PBGC if a major firm went bankrupt. In that event, some officials suggest, the premium increase needed to fund liabilities might be unacceptable and other solutions might have to be found. In the same vein, Ms. Munnell has suggested that, with the bankruptcy of a large firm, Congress might have to decide whether to reduce PBGC's guarantees or, more sweepingly, to put the federal government in the business of insuring private pension plans.

Barring such an event, however, the main remedies being discussed should strengthen the insurance system without overburdening the great majority of plan sponsors. Employers, though disagreeing about particulars, generally want to see PBGC soundly funded. Most are resigned to a rise in the premium to the $4-$6 range, recognizing that the current rate is unrealistic. Moreover, plugging the loophole that lets companies hand unfunded liabilities to PBGC for 30% of net worth would bring system-wide benefits, as would a compromise on the liability question with respect to subsidiary sales or spinoffs.

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Tax Reform. *Basic changes in the tax system are under study in Washington. Hottest idea: a tax on consumption rather than income. Chief aim is to encourage saving. The benefits—and drawbacks—of various reform proposals.* 1

Economy Watch. *Recovery is far from robust. Real GNP growth seems likely to slow below the first quarter pace. Latest projections.* 7

New Monitor. *The Fed has enlarged its tool kit for tracking the economy. A new credit aggregate will serve as a cross-check on money flows. What it is, how well it has worked.* 10

Long-range Forecast. *Decade of the 1980s got off to a soggy start. But activity is perking up. A new look at growth ingredients suggests that the 1980s may well outperform the 1970s.* 13

The New Focus on Consumption Taxes

THE income tax code of the United States is considered to be among the world's most complex. Tax-weary Americans, struggling to meet this month's filing deadline, once again are being reminded of that unpleasant reality.

President Reagan, on the second anniversary of his inauguration, reaffirmed his commitment to tax simplification. Congress, too, wants to rewrite the rules and reform the system. Changes now under study by the Treasury and the Council of Economic Advisers range from revisions of the income tax (for example, adopting a "flat-rate" tax) to the introduction of a new approach: levies on spending rather than on income.

The latter, a broadly based consumption tax, is the hottest idea at present—mainly because it would raise needed revenues for the Treasury and still be consistent with the Reagan Administration's basic supply-side goal of spurring saving, investment, and economic growth. The U.S. has a net investment rate that is only about half of the average among other major industrial countries (chart on page 3). Economic analysts have long viewed the tilt of the U.S. tax structure toward heavy reliance on income levies as a critical factor in encouraging spending and discouraging saving and investment. A tax on consumption would reverse that tilt.

Actually, the U.S. already has taken the first steps toward a consumption tax. Funds placed in Individual Retirement Accounts and Keogh Plans can be deducted from income and, thus, reduce tax liabilities. And the President's plan to allow income to be set aside in tax-free college tuition accounts would be another step in the direction of a consumption tax.

A comprehensive tax on consumption could take a variety of forms. There could be, for example, a simple levy on certain types of spending. Or a general sales tax could be applied at the retail level. Or a "value-added" tax could be levied at various stages of production–an approach popular in Europe.

Any redesign of the tax system could have a variety of revenue objectives. One could be simply to replace the present income tax, in whole or in part, with some form of consumption levy–leaving tax revenues at current levels. Another aim of reform might be to retain the present income-tax-based system and supplement it with consumption taxes in order to augment the Treasury's tax take. A third possibility might be to scrap income levies and introduce consumption taxes at rates that would yield a net revenue gain.

The third possibility–consumption taxes that would replace the present system and produce added revenues–has appeal for two reasons: It would encourage added saving and it would help to reduce the staggering problem of massive budget deficits. Indeed, if Congress in fact acts on reform, the major prod will be the need to address the nation's budget challenges.

How might tax reform under various consumption tax approaches work? What would be the benefits and the drawbacks for individuals and for businesses? Here is an analysis of the key proposals now being studied.

Simple Consumption Tax

One proposal that is being given active consideration by the Administration would replace the current income tax with a simple consumption tax. The tax would work this way:

Each individual would add up all of his cash receipts for the year and then subtract his savings, including additions to bank accounts, purchases of stock or other assets, and repayments of loans. The difference between total receipts and total savings would be the base that is used to determine a person's tax liability.

Capital gains realized from the sale of an asset would increase the consumption-tax base unless the proceeds were reinvested in other capital assets or added to bank or cash balances.

Funds obtained by borrowing would be included in the consumption-tax base. But such funds could be excluded if used for investment in financial or real assets.

Administration officials stress that any desired degree of progressivity could be attained through the rate schedule.* Moreover, major deductions could be retained while still keeping the system based essentially on consumption.

As an example, state and local taxes could be deducted under the rationale that such payments do not represent personal consumption by the taxpayers. Charitable contributions might be considered to be simply the transfer of consumption power. And even personal health-care costs–if prompted by serious illness–could conceivably be deducted on the ground that they are not voluntary spending.

Such a system clearly would stimulate personal saving, as a dollar saved would become a dollar of tax deduction earned. Still, such a system would be far from problem-free. Among the new complexities for taxpayers–and for tax collectors:

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*For example, assume that the top tax rate was 50% and the lowest rate was 20%. With an income tax, a $100,000 executive (assuming no exclusions) would pay $50,000 in taxes. But, under a consumption-tax system, if the executive saved $35,000 he would be taxed on only $65,000–a tax of $32,500 instead of $50,000.

A computer programmer who saved $3,000 of a $20,000 income would pay 20% of $17,000–$3,400 instead of $4,000 under an income tax.

In both cases there would be incentives to save, but the tax system would remain progressive.

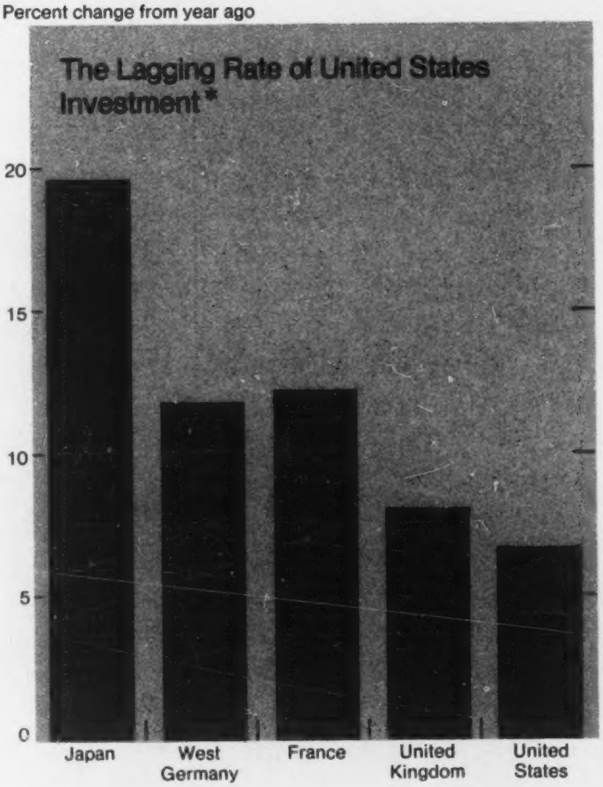
Housing. If rent payments were included in the consumption-tax base, tenants would be discriminated against relative to home owners. Estimates of the imputed value of owner-occupied housing could be devised, of course, but such calculations for the wide variety of housing in the United States would be a major task.

Consumer durable outlays. An automobile or a major appliance yields benefits over a number of years. Some spreading of the purchase price over several years would prevent the lumping of the expenditure (and, thus, a stiff tax bill) in a single year. But any allocation procedure would introduce new complexities into the tax law.

Hoarded cash. Imposition of an expenditure tax would require a determination of an individual's initial asset holdings. If the public thought that adoption of a simple consumption tax was probable, many individuals might attempt to minimize future tax liabilities by building up cash holdings. Money thus spirited away could be used–free of taxes–to supplement future consumption.

"Underground economy." A simple consumption levy probably would not reach people in the underground economy since they would not report either income or saving. For others, any illegal funds could be directed into savings accounts and used to reduce a person's consumption tax liability. Enforcement problems could obviously be a major headache for tax collectors.

Loans. Individual lenders could treat loans as savings under a consumption levy. As a result, some high-tax-bracket individuals might make loans to friends or relatives who were in lower tax brackets. These friends, in turn, could then purchase goods on behalf of the lender. Detection of this form of tax avoidance would be extremely difficult.


The Lagging Rate of United States Investment*

* Net fixed investment.

Source: Organization for Economic Cooperation and Development.

Gifts and bequests. An individual saver can give gifts during his or her lifetime or can leave a bequest at the time of death. A key issue under a consumption levy would be whether the gift or bequest should be included in the donor's or donee's tax base. On the one hand, a consumption tax is intended to impose a levy at the time of final purchase, and it is the donee not the donor who would engage in the act of consumption. To be fair, the tax would have to be applied to the donee's consumption but not to the donor's gift or the donee's saving. But such a levy might result in large-scale tax avoidance by wealthy families, who might transfer assets and ultimately spending from members in high tax brackets to members in low brackets. If, on the other hand, the donor's gift or bequest were taxed as consumption, double taxation

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would occur since a tax also would be levied on the donee's purchases.

Record keeping. Individuals would be required to furnish detailed balance-sheet information on cash balances, bank accounts, and other asset holdings. In addition, detailed record keeping would be needed for purchases of durable goods. For the typical taxpayer, such requirements might be more time consuming and complicated than are present record-keeping and compliance rules.

"Flexible" Consumption Tax

The flexible consumption tax, outlined in a staff study by U.S. Treasury officials in the late 1970s, is supposed to ease compliance problems for taxpayers and enforcement problems for tax collectors. The basic idea would still be to deduct saving and investment from income. But the Treasury study proposed the setting up of two special accounts–qualified and nonqualified.

Deposits into qualified accounts–as well as interest, dividends, and capital gains earned on the accounts–would be excluded from the tax base. Withdrawals would be included in the tax base. These accounts thus would be similar to existing IRAs, except that no limit would be placed on deposits or withdrawals.

Investments or deposits into a nonqualified account would be included in the expenditure tax base. But any return on the investments or any withdrawals from the nonqualified accounts would escape taxation.

This dual account system would resolve some of the more difficult administrative and enforcement problems associated with the simple expenditure tax. An individual considering the purchase of a house or an automobile, for example, could choose to borrow from a nonqualified account. Otherwise, the taxpayer would have to include the entire purchase price in the consumption-tax base. Loan payments (interest and principal) would flow into the nonqualified account during the repayment period and would be included in the consumption-tax base. These payments, thus, would be a rough measure of the imputed rental value of owner-occupied housing and the imputed depreciation of consumer durables.

The Treasury's flexible consumption tax also would reduce the burden of reporting detailed information on cash balances and other asset holdings. The result would be a significant reduction in compliance costs.

While the Treasury's plan would solve some problems, others would remain. The hoarding of cash at or before the announcement of the expenditure tax would continue to plague tax authorities. And large capital gains in the nonqualified accounts would escape taxation even if the gains were used for consumption. These gains would allow some individuals to step up consumption with no increase in their tax liability. According to the Treasury's study, this difficulty could be resolved by requiring that all speculative ventures be placed in qualified accounts. However, it is open to serious question whether the IRS or anyone could fully anticipate the risks and returns on all forms of investment–and decide which type of account should be used. The creation of qualified accounts earmarked for specific purposes also would introduce the government into the business of allocating saving and investment flows. This possibility clearly is worrisome.

And the flexible consumption tax would do little to solve the problem of tax evasion. Under the Treasury plan, individuals still would have to file returns that add up cash receipts and deduct saving. As in the case of the simple consumption levy, those in the underground economy would not file—and would continue to escape taxation.

In sum, the creation of qualified and nonqualified accounts may substitute one complex tax structure for another and may fail to curb tax evasion. But such a change could be worth the time and the effort if it encourages more saving.

Value-Added Tax

Under this levy, the tax base is a firm's gross receipts less the value of all purchased intermediate products as well as any outlays for capital goods. In calculating its tax liability, a firm simply applies the tax rate to its total sales receipts and then deducts a credit for the value-added taxes paid to suppliers of intermediate and capital goods.

The value-added tax (VAT) has the advantage of being to a considerable extent self-policing, since the tax liabilities of one firm become the credits of another. The burden of the tax ultimately falls on the final consumer, since the producers find it to their advantage to pass the tax on at each successive stage of production.

To place foreign-produced goods on the same tax footing as domestically produced goods, VAT systems provide that a fee—equal to the VAT rate—be levied on all imports. And, on the presumption that exported goods will be subject to other countries' levies, exporters receive rebates from their own governments of VAT taxes paid. This refunding is permitted under the rules of the General Agreement on Tariffs and Trade (GATT).

The refunding gives a competitive advantage in international trade to countries that rely on VAT relative to countries like the U.S. that have income-tax levies. Under GATT rules, corporate-income taxes cannot be refunded. The shift to a VAT, therefore, would improve the overall competitive position of the U.S. relative to foreign countries by placing the U.S. on a par with others. Moreover, VAT has the added advantage of not distorting economic decisions among products or among methods of production. This tax neutrality is one of the strongest arguments in favor of substituting a value-added tax for an income tax.

Still, VAT is not without problems. The tax has been criticized as being regressive—that is, falling most heavily on low-income taxpayers. This objectionable feature could be alleviated by exempting certain items (food, clothing, and shelter) from the tax base. However, attempts to solve the equity problem by exempting such goods would compromise the neutrality of the tax by distorting market prices.

The substitution of a VAT for the personal income tax would bring a bulge in prices as measured by the consumer price index. But major price adjustments would not recur, except to the extent that indexed wage contracts boosted underlying labor costs. The problem of a sudden rise in prices might be less disruptive if the tax were imposed during a period of declining inflation. Nevertheless, the price-index impact of VAT has to be a major worry, especially in light of the rapid runup in price indexes that occurred in 1979 when the British government increased value-added taxes.*

The VAT system requires that all manufacturing, wholesale, and retail firms file returns. All told, this would involve around 15 million taxpayers, a much lower total than the 110 million individual and corporate tax filers under the present income-tax system. The substitution of a VAT for an income tax or a flexible consumption tax also would eliminate the potential for evasion by taxing participants in the underground economy as they purchased goods. Nevertheless, barter transactions would continue to escape taxation.

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*While the VAT would increase price indexes, individual well-being might be little affected. That would be the case in those instances where, at present, the corporate tax is being shifted forward to consumers in the form of higher prices. Moreover, if VAT were to be substituted for the personal income tax, higher prices would be offset by higher disposable income.

General Sales Tax

Compared with VAT, a sales tax levied at the point of final sale would involve far fewer tax filers, since manufacturers and wholesalers would be allowed to purchase intermediate goods without an increase in their tax liability.

The sales tax also is a simpler levy for businessmen to understand and to comply with, since it requires only a record of final sale. And the tax has the additional advantage that most retail firms are familiar with its operation at the state and local level. Thus, the tax could be "piggy-backed" with state and local sales taxes.

The retail sales tax does have the disadvantage that it is regressive and, like the VAT, it does have a one-time inflation effect. But this problem could be eased by exempting essentials such as food, clothing, shelter, and medical services.

A national sales tax would be a potent revenue raiser. If essentials were excluded, each 1% increase in the tax rate would raise $10 billion. This revenue-raising potential would increase the risk that Congress would use the funds to enlarge spending programs and worsen the already bleak outlook for the federal deficit. Clearly, the use of a national sales tax to encourage saving would have to be accompanied by a curb on new spending programs.

Which tax?

Reforming the tax system, obviously, would be a major undertaking, given the triple challenge of tax simplification, encouragement of saving and investment, and reduction of the structural budget deficit. The alarming size of projected deficits–and resistance in Congress to further sizable reductions in spending–suggests a pressing need to raise additional revenue. Increased emphasis on consumption taxes clearly should be considered.

The type of consumption tax requires a careful evaluation of both the benefits and drawbacks of each proposal. Substitution of a flexible consumption tax for the income tax would improve saving incentives and simplify tax compliance in some ways–by eliminating many accounting definitions such as those pertaining to capital gains and depreciation. But the flexible consumption tax–with its system of qualified and nonqualified accounts–would introduce complexities of its own. Indeed, the net result might be a system more complex than the existing one.

Some variations of the consumption-tax idea –VAT or a general sales tax–appear to have fewer administrative problems. Even so, each would risk worrisome effects on the rate of inflation and on the progressivity of the tax code. Of the two, the retail sales tax appears to hold the greater potential because of its simplicity and familiarity.

Clearly, tax simplification and reform are needed if the nation is to encourage the saving and investment needed to revitalize capital formation. A properly designed tax on consumption could play an important role in achieving such a goal while at the same time reducing the budget deficit.

Economy Watch

INCOMING data underscore the tentative character of the recovery. With the exception of the housing statistics, recent readings point to a pace of economic activity that is far from robust.

Employment in the nonfarm economy, for example, grew at an annual rate of 0.5% this past quarter—an improvement, to be sure, but one that suggests cautious attitudes toward rehiring. At the same time, average weekly hours only inched up. As a result, wages and salaries, the bulk of total personal income, grew at a moderate pace (an estimated 6% at an annual rate). Continuing slippage in the unemployment rate has been a positive development—one that probably helps explain the recent improvement in consumer sentiment indexes. It is important to recognize, however, that a sizable drop in the labor force in recent months has contributed importantly to the drop in the unemployment rate. That unusual shrinkage in the work force cannot be expected to persist.

The impetus to recovery apparently continues to come mainly from a turnaround in inventories from record rates of decline late last year. With such reductions behind it, business—the auto industry in particular—was set up to boost output significantly.

Helpful as the inventory swing has been in getting the recovery started, however, it is a force that inevitably is spent quickly. Reduced momentum from inventories is the key reason behind The Morgan Bank's judgment that growth of real GNP will slow from an estimated annual rate of 4.7% in the first quarter of the year to under 3% in the current quarter (table on this page).

For economic activity to continue at the first quarter's pace would require a sharper pick-up in final sales (total spending other than inventory investment) than now seems likely. Although the upswing in housing is solidly entrenched, leading indicators of business investment are not promising. Orders for nondefense capital goods, for example, which had risen at an annual rate of 7% in the fourth quarter of last year, declined in the first few months of this year. Contract awards for nonresidential construction also retreated.

Even more disappointing has been the performance of auto sales. These spurted in November when cut-rate financing was introduced. But since then, sales of domestic-make cars have been flat at an annual rate of about 6

Economic Projections

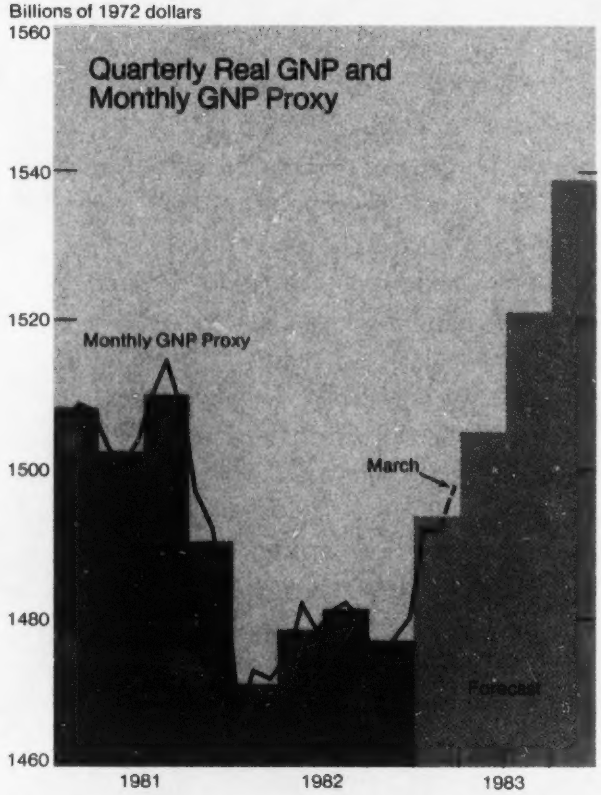
(Percent change at annual rate from previous quarter, except where noted)

	1982	*1983*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−1.0	4.7	2.9	4.4	4.8
Real consumer spending	4.5	2.5	3.3	3.9	4.4
Real business-capital outlays	−6.0	−5.6	−1.4	1.5	3.7
GNP deflator	3.7	3.9	5.7	4.6	4.1
Consumer prices	2.0	−0.2	4.3	5.1	5.3
Real disposable personal income	0.3	1.2	3.7	6.1	3.7
Saving rate (%)	6.0	5.7	5.8	6.3	6.2
Housing starts (Millions)	1.3	1.7	1.7	1.7	1.7
Auto sales (Millions)	8.7	8.4	8.6	8.9	9.2
Unemployment rate (%)*	10.7	10.4	10.4	10.4	10.3

Note: 1982 Q4 data are actual. *Civilian labor force.

million units—a level unlikely to trigger a further increase in output. Thus, the significant prop that higher auto output gave to production this past quarter is expected to weaken. Detroit, meanwhile, is attempting to reinvigorate sales by further reducing finance charges on small cars. Elsewhere in consumer markets, the trend has been upward—with pockets of strength evident in key cyclically sensitive categories of sales. And certainly reports on March sales from major retailers were upbeat, even though early Easter buying probably helped the performance of sales that month. With auto sales languishing, however, the pattern in overall buying has not been especially spritely: Total consumption outlays in real terms appear to have risen at an annual rate under 3% this past quarter. Income growth was even more subdued, and thus the personal saving rate—which fell sharply late last year—continued to slip. With the saving rate almost a full percentage point below its average last year (and comparatively low in historical perspective), little room exists for aggressive spending increases by consumers. Indeed, there is a good chance that the saving rate will rise a bit, given the incentives provided by IRA accounts and by money market yields on savings deposits.

Finally, foreign-trade trends continue to be a major negative in the outlook for final sales. Although the trade deficit of the United States has narrowed somewhat recently as oil imports have fallen dramatically, imports of other goods have surged. As a result, a growing portion of domestic demand was lost to foreign producers. U.S. exports have remained weak.



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

Renewed strength of the U.S. dollar internationally suggests that foreign-trade constraints on U.S. economic performance will continue. The foreign-exchange value of the dollar had begun to slip late last year following the decline in U.S. interest rates. But in recent weeks the dollar on a trade-weighted basis has returned to within one percentage point of the high it set last November.

This seems to reflect widening spreads between U.S. and foreign interest rates. The spread between three-month Eurodollar and Euromark rates, for example, which had averaged 300 basis points in the fourth quarter of last year, is now about 500 basis points. Widening spreads reflect the decline in foreign interest rates at a time when money markets in the U.S. tightened.

Early this month, short-term interest rates in this country were running about 50 to 75 basis points higher than in early March, reflecting pressure in the Federal funds market. The tendency of the funds rate to move up to over

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9%, following several months of stability in a narrow band around 8½%, was probably due mainly to special factors. Many banks try to maximize the liquidity of their balance sheets on quarterly statement dates. Such "window dressing" may have created unusual money market demands in late March and early April—just as it apparently did at the turn of the year when the funds rate ran up briefly to over 10%. In addition, the demand for reserves in late March and early April may have been unusually strong because of the early Easter and the associated currency needs of the public. While presumably the Fed took this into account in providing reserves, it is always hard to know in advance precisely to what extent holiday demands for cash will drain bank reserves.

These factors notwithstanding, pressures in the market for bank reserves raised suspicions that the Federal Reserve had decided to become at least slightly less accommodative. A year or so ago, fluctuations of about half a percentage point in the funds rate would not have raised broad questions about policy. Rather, such fluctuations would have been ascribed to the Fed's strategy of targeting reserves and allowing the funds rate relatively free rein. In view of the notable stability of the funds rate since late last year, however, the tightening in money markets took on special significance. It raised the basic question as to whether the Federal Reserve was actively moving to curb the rapid growth of the monetary aggregates—despite repeated statements to the effect that such growth must be discounted heavily because of unusual precautionary demands for monetary assets and because of new deposit instruments.

As yet there is no clear-cut answer to that question—although comments reportedly made by a "senior Federal Reserve Board official" earlier this month conveyed the distinct impression that Fed policy had not triggered the firming in money market rates. The just-released record of policy actions taken at the Federal Open Market Committee (FOMC) meeting in February, moreover, continued to underscore the need for caution in interpreting the aggregates. The record is replete with references to the fact that the relationship between money and credit growth, on the one hand, and income and expenditures, on the other, has changed markedly—and cannot be expected to

THOSE LAGGING TAX REFUNDS

TAX refunds from January 1 through March 25 amounted to $20.5 billion, down $2.6 billion from the same period last year.

The lag is due primarily to a processing backlog. In the filing period between January and late March, for example, the Internal Revenue Service processed only 70% of the returns filed by taxpayers this year—as against 77% of those filed in the same period last year.

The refund pace is likely to pick up in the weeks ahead as the backlog of unprocessed returns is worked down. Moreover, a last-minute filing rush is expected as people invest in Individual Retirement Accounts in order to reduce their 1982 tax bills and, hopefully, qualify for a refund.

Personal refunds so far this year have averaged just over $700 each, up 1% from last year. Assuming that the size of the average refund rises (reflecting the influence of the IRAs), total refunds for the fiscal year seem likely to reach the Treasury's estimate of $65 billion—up some $10 billion from last year.

Some private analysts have been forecasting as much as a $25-billion rise in tax refunds. In order for that to happen, the average refund from this point on would have to be 50% higher than the current $700 average. Even with IRAs, that is most unlikely.

return quickly to normal. Consequently, the FOMC continued to stress the need for "an unusual degree of judgment" in interpreting trends in the monetary aggregates. Some FOMC members, in fact, questioned the wisdom of even stipulating an annual growth target for M1. Moreover, the FOMC chose to forgo "interim" or short-run targets not only for M1 but for the broader aggregates M2 and M3 as well.

Some FOMC members contended that M1 should be given greater weight in policy formulation and others favored more discipline with respect to the aggregates generally. All in all, however, the latest detailed articulation of policy failed to signal any material change in the willingness of the authorities to play down the significance of recently rapid monetary growth. In light of the policy record—and of incoming data suggesting that recovery in the economy is proceeding at a moderate pace—it seems unlikely that the recent firming in short-term interest rates marks the beginning of a significantly more restrictive monetary policy. The firming, at the same time, adds to the Fed's reputation as a staunch opponent of inflation.

The Fed's New Credit Aggregate

THE Federal Reserve Board announced in mid-February that it will begin monitoring a comprehensive credit aggregate. It also announced a range of growth for the new measure that is "associated" with the target growth rates set for the money aggregates in 1983.

The credit growth range—8½% to 11½%—does not have the status of a target. Rather, the Fed will use it as a "cross-check" on monetary measures—affording another perspective on economic and financial activity. Many analysts have argued that information from the new credit measure can compensate for false signals given by the money aggregates. A close look at the way the credit aggregate has behaved recently, however, suggests that it, too, can be a misleading guide for policy.

The credit aggregate is the total debt of domestic nonfinancial sectors, as derived from the Fed's flow-of-funds accounts. The measure includes borrowing by private entities and by federal, state, and local governments in U.S. markets and abroad. It excludes borrowing by foreign entities in the United States. It also excludes corporate equities.

The Fed chose that aggregate after analyzing several potential measures of credit for the stability and predictability of their relationships with GNP and other economic variables. Whether any aggregate—monetary or credit—has a close and stable relationship with the economy is one key test of its utility. The credit measure selected was judged to have about as close a relationship with GNP as the money aggregates. In addition, according to the Fed, the domestic nonfinancial debt total "generally performed as well as or better than the other series considered" with respect to stability and predictability.

A useful way of gauging how stable the link is between credit and economic activity is to look at the velocity of credit. This is simply the ratio of nominal GNP to the level of credit—a concept analogous to the velocity of money.

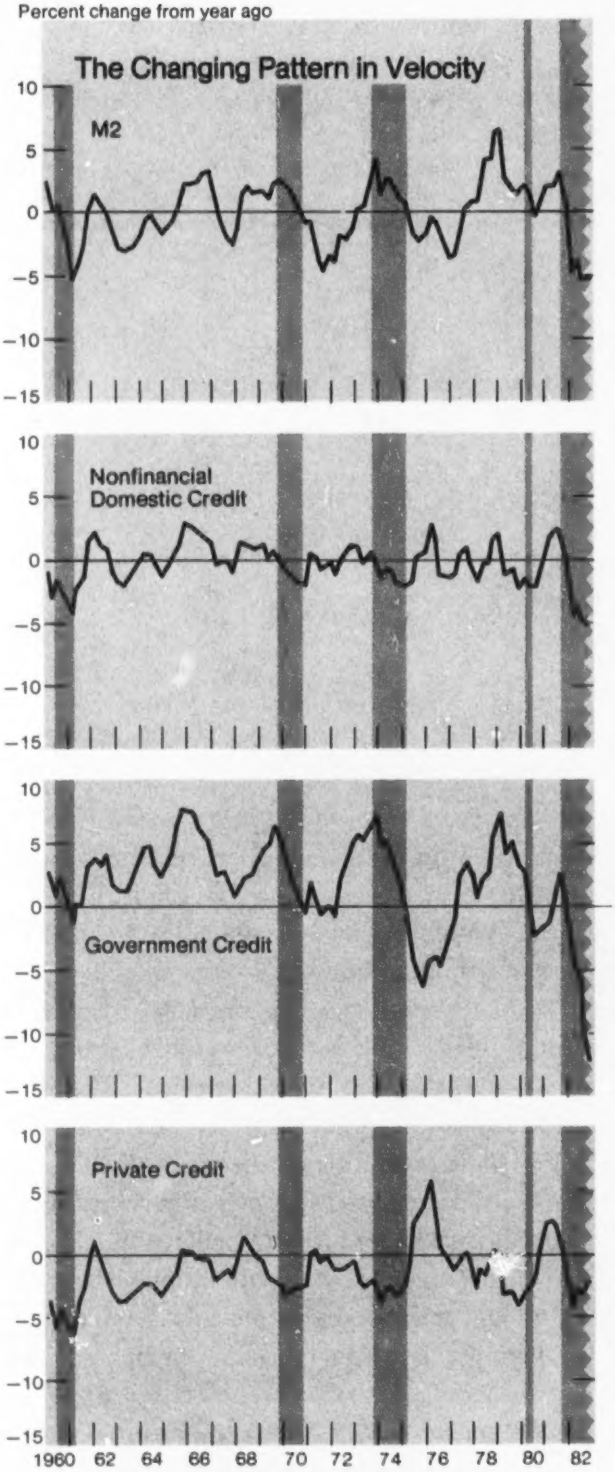
Thus, credit velocity measures how many dollars of economic activity are carried out with a single dollar of credit.

Looked at in this way, the credit-GNP relationship has shown considerable volatility over the past two decades (chart on this page). This is also true of the M2-GNP relationship. While the range of variation in credit velocity has been somewhat smaller than that in M2 velocity, it should not be inferred that the credit-GNP relationship is more stable than the relationship between money and GNP. In fact, statistical tests suggest that the opposite is true.*

Significantly, both credit velocity and money velocity declined sharply from mid-1981 through 1982. The drop in credit velocity was particularly sharp compared with its behavior during previous recessions. The reason: Credit demand grew much more rapidly throughout the 1981-82 recession than in past downturns.

At the federal level, the government stepped up borrowing in order to finance the deficit—which was enlarged by tax cuts and increases in defense spending. At the same time, several factors prompted state and local governments to increase their borrowing at record rates—especially during 1982.** Thus the ratio of GNP to government credit showed a sharper decline during the recent recession than is typical during downturns (third panel of chart on this page).

There was also strength in private credit



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981 whose terminal date remains open.

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*Such tests are discussed in James Fackler and Andrew Silver, "Credit Aggregates as Policy Targets," Federal Reserve Bank of New York *Quarterly Review*, Winter 1982-83.

A drawback of the new aggregate is that credit data are only available on a quarterly basis—and with a six-week delay. Many of the components of the aggregate are collected (and monitored) on a monthly basis, but a monthly measure of the credit total, although under study, will not be available any time soon.

**These factors are discussed in "Credit Markets in 1983," *The Morgan Guaranty Survey*, January 1983.

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Change in Domestic Nonfinancial Sector Debt

(Fourth quarter to fourth quarter)

Year	*Percent change*	*Year*	*Percent change*
1963	6.9	1973	11.3
1964	7.2	1974	9.3
1965	7.2	1975	8.9
1966	6.9	1976	10.7
1967	6.8	1977	12.3
1968	8.4	1978	12.9
1969	7.1	1979	12.3
1970	6.9	1980	9.9
1971	9.3	1981	10.1
1972	10.0	1982	9.1

growth during the early stages of the recession, concentrated in business borrowing. That strength reflected several factors: weak cash flow and relatively strong business investment; an extended bout of merger activity financed by bank loans; and a relatively weak stock market until mid-1982 that inhibited equity issuance. Thus, as shown in the fourth panel of the chart, the ratio of GNP to private nonfinancial credit declined more sharply in late 1981 than is typical during economic downturns.

While the behavior of the credit-GNP relationship in the past two years was atypical, so was that of the M2-GNP relationship. In the latter case, atypical behavior mainly reflected financial market deregulation and a buildup of liquidity by individuals. The coincidental departure from past patterns points up a flaw in the argument that if the relationship between one aggregate and GNP goes haywire the behavior of the other aggregate will give reliable signals about the pace of economic activity.

The fact is that the Fed cannot rely solely on the aggregates in making policy. Similarly, financial market participants cannot judge policy simply by analyzing the aggregates. Though some analysts have an "understandable yearning," as Fed Chairman Paul Volcker noted recently, to "encompass all policy considerations in a simple, relatively rigid rule," this cannot be done. "Elements of judgment," Mr. Volcker said, "seem to me inevitably necessary in interpreting the data. . ."

Such a pragmatic approach to policymaking reflects the Federal Reserve's concern with achieving its ultimate targets—including stable, noninflationary growth and high employment. Hence the Fed has since mid-1982 relied on judgment rather than on a rigid targeting rule in fashioning policy to foster moderate economic growth without rekindling inflation. As the Federal Open Market Committee (FOMC) noted in its record of policy actions taken this past February: "Against the background of sharply declining velocity, the Committee had concluded that rigid adherence to the 1982 targets would have resulted in a much more restrictive policy impact than had been intended."

Monitoring credit

Over the four quarters of 1982, the credit aggregate grew 9.1%, slightly more than its 8.7% average annual increase during the past 22 years (table on this page). The growth range for the new measure for 1983 (8½% to 11½%) is about in line with expected growth of nominal GNP. However, the Fed, in a report to Congress in February, suggested that, "in the particular circumstances of 1983, somewhat more rapid growth of credit also might be consistent with . . . overall objectives."

Consideration of the new credit aggregate enlarges the information base on which the Fed relies in shaping policy. However, there is no guarantee that credit will be any more reliable an indicator than are the money aggregates. Indeed, if the Fed had been relying on its new credit aggregate for policy guidance last year, when both credit and money aggregates expanded, it would have been misled as to appropriate action.

The 1980s Reconsidered

AFTER a painfully slow start, the 1980s finally are showing signs of life. Considerable worry about whether cyclical recovery will prove sustainable still exists, but most forecasters are now formally projecting rising economic activity in the U.S. into 1985.

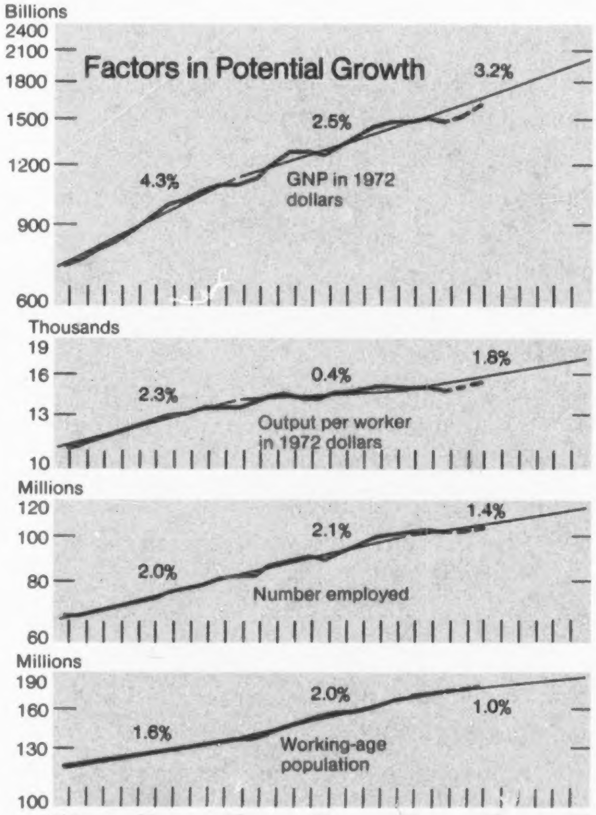
But what are the longer-term prospects? How will the 1980s stack up compared with the decade of the 1970s?

Four years ago The Morgan Bank presented its forecast of economic activity for the decade ahead.* The outlook for the early years was "not especially bright." Still, the Morgan analysts did not expect four years of virtual stagnation and two back-to-back recessions.

Happily, that unusually dismal period now seems to have come to an end. The chief reason is that inflation, which has been at the root of the economy's ills, has been significantly weakened. A reduced rate of inflation should allow monetary policy to support economic expansion for some years into the future.

Growth ingredients

Morgan's 1979 forecast for the decade of the 1980s as a whole was reasonably optimistic. An analysis just completed tends to confirm the earlier findings: The 1980s appear likely to be a decade of moderate growth and rising living standards.



Note: The thin black lines are trends, fitted as straight lines for each of the 10-year periods. The colored lines are the actual data through 1982 and as forecast (dashed line) by The Morgan Bank for 1983 and 1984. The percentage figures are the annual growth rates for each of the trends.

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*The Morgan Guaranty Survey, February 1979.

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The total amount of goods and services provided by the economy–gross national product–depends on the size of the population of working age, the proportion of the population willing and able to work, and the amount produced by each worker.

The behavior of each of these factors in the 1960s, the 1970s, and as projected for the 1980s is shown in the chart on page 13.

Working-age population. The growth rate of the working-age population will slow dramatically during the 1980s as a result of the sharp drop in the birth rate following the post-World War II "baby boom." During the current decade, the potential labor force–the so-called noninstitutional population 16 years and over–is expected to increase at barely more than a 1% annual rate. This compares with a 1.6% average annual growth rate for this population group during the preceding 30 years.

The 30-year average takes into account an unexpected 3.3-million addition to the potential labor force revealed by the 1980 census. That added 0.2 percentage points to the calculated growth rate of the working-age population during the 1970s.

The greater-than-expected number of adults appearing in the 1980 census is thought to have been mainly the result of a more aggressive count of the population than was made in the 1970 census, although illegal immigration may also have been a factor. In its projection of future population growth, the Census Bureau has assumed net immigration of 450,000 per year, compared with an average of 400,000 per year during the 1970s.

Employment. The number of people employed increased at a faster rate in both the 1960s and 1970s than did the population of working age. That pattern is expected to continue through the 1980s, partly because today's unusually large pool of unemployed will shrink as the economy expands. An added reason: a continued increase in the proportion of the population of working age seeking work–i.e., a continued increase in the so-called participation rate. Between 1970 and 1980, the fraction of the civilian noninstitutional population 16 years and over employed or seeking employment rose from 60.4% to 63.8%. Moreover, all of the increase was the result of a rapid rise in the participation rate of women; the participation rate of men continued to fall. In 1981 and 1982, however, the total participation rate, while continuing to increase, slowed markedly and is now well below what had been projected by the Bureau of Labor Statistics earlier in the decade as its "middle growth path."

To some extent the less-than-expected participation undoubtedly reflects the recession and the knowledge that jobs are not readily available. An acceleration in the growth of the participation rate will probably occur with a pickup in economic activity, but there is little reason to expect the participation rate to revert to its previous trend. The employment projection shown in the chart on page 13 (a 1.4% annual rate of increase for the decade of the 1980s) incorporates only a moderate further increase in the participation rate and a reduction in the unemployment rate to 6% by 1990.

Output per worker. Productivity may be taking a turn for the better. Output per worker rose in the second, third, and fourth quarters of last year despite the recession. Productivity normally declines during a recession because the volume of output falls faster than the number employed. But in the 1981-82 recession, business managements seem to have gone all out to control costs–a hopeful sign that the era of focusing exclusively on sales, and passing along higher costs in the form of higher prices, has come to an end. If, as seems likely, managements continue to concentrate on keeping labor costs under control as the recovery picks up momentum, there is a good chance that gains in output per worker during the second half of the 1980s could approach the impressive performance of the 1960s. To bring that about, there will need at some point to be a substantial pickup in net capital investment, but the stock of capital is not a near-term constraint.

GNP. All in all—and despite the inauspicious beginning—the trend rate of growth in real GNP during the 1980s may well be about the same as was projected four years ago. The expected increase in the growth rate of output per worker would be more than sufficient to offset slower growth in the labor force during the 1980s, provided there is adequate demand for the nation's output of goods and services. That, in turn, will depend importantly upon managements' continued restraint in setting prices and wages. Given the prospects for continued overcapacity of both workers and machines for some time to come, that is not too much to expect.

If the forecast turns out close to the mark, it would push real GNP (in 1972 dollars) to just over $2 trillion—an increase of some $560 billion (38%) above the level at the start of the decade. To be sure, the 3.2% growth now foreseen for the 1980s would be well below the 4.3% of the 1960s. But it would be a substantial improvement over the 2.5% of the 1970s.

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Profits Upsurge. *After a dismal performance in 1982, profits are on the rebound. Look for a 30% increase this year—considerably better than gains in most past recoveries. The key forces behind the rise.* 1

Economy Watch. *Prospects for near-term growth have brightened. Latest projections, quarter by quarter, as the recovery moves into its fifth month.* 5

Business Borrowing. *Credit needs of corporations seem likely to fall far short of those in past recoveries. Reasons why—and the implications for credit markets.* 7

Housing Miniboom. *Responsible for the upswing: pent-up demand, improving affordability, and a flourishing secondary mortgage market. Sizing up the housing potential.* 11

Profits Rebound: Strong and Getting Stronger

FIRST-QUARTER earnings reports indicate that a healthy rebound in corporate profits is under way. Although some companies remain to be heard from, the reports so far show a strong reversal of the dismal performance in 1982, when recession-hit profits sagged 15%. And further improvement is likely as the year wears on—even if, as expected, the recovery turns out to be modest compared with earlier upswings (Economy Watch, page 5).

The Morgan Bank projects more than a 30% gain this year in pretax "economic profits." This measure is a good indicator of basic profitability, because it excludes distortions caused by swings in inflation-related inventory profits and calculates depreciation on a replacement cost basis. Conventionally measured profit aggregates, too, should show strong gains in 1983.

The prospective profits upsurge will far outdistance all but one of the rebounds that accompanied other cyclical recoveries since World War II. During the first four quarters of the past six recoveries, profits rose an average of 23% from their average level in the preceding four quarters (table at top of page 2).* During five of those recoveries the gain in profits was around 20%. Only the profit upswing that followed the 1974-75 recession, which was a particularly strong 35%, outdistanced the profits surge expected this time.

The sources of the recovery in profits are also likely to distinguish the current cycle.

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*Since the trough of the current cycle generally is considered to be the fourth quarter of 1982, the gain in profits in calendar 1983 will correspond to the gain in the first four quarters of the recovery.

Cyclical Swings in Profits

(Percent change)

Cyclical trough	*Year prior to trough*	*Year following trough*
1949-Q4	−7.6	24.7
1954-Q2	−11.1	22.6
1958-Q2	−12.5	21.5
1961-Q1	−9.9	17.9
1970-Q4	−16.1	16.6
1975-Q1	−13.1	35.1
Average of six cycles	−11.7	23.1
1982-Q4 (proj.)	−15.2	33

Note: Estimates are for pretax economic profits, which exclude inventory profits and are based on replacement-cost depreciation deductions. Percent changes are for the average of the four quarters prior to, or following, the economic trough compared with the average of the previous four quarters.

Less of the expected profit growth is attributable to an improvement in the price-labor cost relationship for nonfinancial corporations and more is attributable to a slowing in capital costs and to a surge in the profits of financial institutions than was typical of past cycles.

Prices and productivity

During recoveries, a key source of strength for the profits of nonfinancial corporations (which represent approximately three-fourths of total profits) is an increase in prices that exceeds the rise in unit labor costs. Productivity (output per man-hour) usually goes up rapidly during the early stages of the expansion as rehiring lags behind output growth. This, in turn, reduces the rate of rise in unit costs and leads to a widening of margins. The rate of price increase following the 1974-75 recession exceeded the rate of increase in unit labor costs by roughly three percentage points, while a margin of two percentage points had been typical of earlier recoveries (table below). This unusually wide gap was the primary reason for the strong profit rebound during that recovery.

This year, profits are unlikely to benefit from as large a gap between prices and labor costs as prevailed in 1975. Output per man-hour has improved dramatically in the past two years, and there is considerable evidence of aggressive cost cutting by corporations. But the recent performance is an improvement relative to only the subpar readings of the late 1970s. While a gain of 3% to 4% in productivity in 1983 appears possible, such a performance would still be somewhat below that of previous recoveries.

In addition, corporations seem likely to be able to achieve only moderate price increases

Prices vs. Labor Costs in Recoveries

(Percent change)

Cyclical trough	*Productivity*	*Compensation per man-hour*	*Unit labor cost*	*Price*	*Price relative to labor cost*
1949-Q4	6.0	5.9	−0.3	2.0	2.3
1954-Q2	3.4	2.9	−0.6	1.5	2.1
1958-Q2	4.3	4.0	−0.3	2.0	2.3
1961-Q1	4.4	3.7	−0.7	1.2	1.9
1970-Q4	3.3	6.6	3.1	5.0	1.9
1975-Q1	3.7	8.7	4.8	8.0	3.2
Average of six cycles	4.2	5.3	1.0	3.3	2.3
1982-Q4 (proj.)	3.0	5.5	2.5	4.5	2.0

Note: Productivity, compensation, and unit labor cost cover the private nonfarm sector. The GNP deflator is used as the measure of price increase. Percent changes are for the average of the four quarters following the recession trough compared with the average of the previous four quarters.

in the months ahead. Oil prices will be down for the year, and industrial prices generally are still showing only modest rates of increase (industrial prices excluding energy have risen less than 2% at an annual rate in the past six months). The impetus to profits coming from the relationship between price increases and labor cost gains, therefore, will be well below that achieved in 1975 and probably somewhat below the average for recovery periods.

Slowing in capital costs

Although labor costs make up about two-thirds of total costs, capital costs (depreciation charges and interest expense) have become increasingly important. These costs have risen from a little over 10% of the total costs of nonfinancial corporations in the 1960s to 16% last year. Now the rise in capital costs appears likely to moderate, providing a lift for profits.

The decline in interest rates (the prime rate averaged 15% in 1982 and is expected to average only slightly over 10% in 1983) is one factor that will constrain capital costs this year. In addition, the level of debt outstanding is expected to increase only modestly (story on page 7). Debt expansion will be constrained by the continuing low level of investment spending. Moreover, the rate of new equity issuance has picked up sharply, reducing the need to enlarge debt burdens.

An added spur to profits is the expected slowing in the rate of increase of depreciation expense. During the past decade, depreciation expenses rose much more rapidly than output. This was largely because the price of capital equipment and construction rose more rapidly than did the value of corporate output. Corporations were thus squeezed between rapidly escalating capital costs and more slowly increasing prices for their output. In the past year, however, this relationship has changed. Output prices have risen around 4½%, while prices of capital goods and construction have remained essentially unchanged. The result has been a sharp slowing in the rate of increase in depreciation charges.*

Sources of Gains in Nonfinancial Corporate Earnings

(Percent change in the year following cyclical troughs)

Cyclical trough	*Output*	*Labor costs*	*Revenue after labor costs*	*Depreciation and interest**	*Profit*
1949-Q4	13.7	11.1	18.2	8.8	28.6
1954-Q2	6.3	2.7	13.6	4.2	26.1
1958-Q2	8.0	5.1	13.7	6.1	26.3
1961-Q1	6.5	4.4	10.4	5.9	22.4
1970-Q4	8.2	6.2	12.3	10.0	18.0
1975-Q1	11.2	6.1	22.1	10.8	59.1
Average of six cycles	9.0	5.9	15.1	7.6	30.1
1982-Q4 (proj.)	6.5	4.5	10.6	4.9	33.1

Note: Percent changes are for the average of the four quarters following the recession trough compared with the average of the previous four quarters.

*Also includes indirect taxes and business transfer payments.

The resulting boost to profits is likely to be considerably stronger during the current cycle than it was in previous cycles. One reason is that capital costs are now much more important. The interest-rate decline and the relative capital-goods price deceleration have also been larger during the current cycle.

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*When calculated on a replacement-cost basis, depreciation charges respond immediately to changes in capital-goods prices. Under the historical cost accounting methods used by corporations for public reporting, depreciation charges respond to changes in capital-goods prices only as the capital stock is replaced.

As the table on page 3 shows, the gain in nonfinancial corporate revenues after labor costs are deducted is likely to be smaller in 1983 than was the case, on average, in past recoveries. This shortfall, however, should be more than offset by an unusually small increase in capital costs. The result should be an increase in the profits of nonfinancial corporations that is larger than in any recovery except 1975.

The biggest boost to overall business profits in 1983 is likely to come from a dramatic upsurge in the earnings of financial corporations. Profits of commercial banks, thrift institutions, insurance companies, and brokerage houses are expected to more than double this year (table on this page). Behind the expected rebound is the sharp drop that has occurred in short-term interest rates. Financial institutions, particularly savings and loan associations and mutual savings banks, have large quantities of long-term assets that are financed by short-term deposits. When short-term interest rates rose in 1980 and 1981 these firms were badly squeezed. As a result, profits of private financial corporations fell from a peak of $24.5 billion in the fourth quarter of 1978 to $3.8 billion in the first quarter of 1982. Last year's declines in short-term rates brought profits of financial corporations back to $14.5 billion by the fourth quarter. The upward trend is likely to continue, though at a reduced rate.

Corporate Profits in 1983

(Billions of dollars)

	1982	*1983 (proj.)*	*Percent change*
Total	160.8	214	33
Domestic earnings	142.7	190	33
Nonfinancial	118.7	158	33
Private financial	8.3	19	129
Federal Reserve	15.7	13	−17
Foreign earnings	18.1	24	33

Note: Pretax profits excluding inventory profits and calculated with depreciation on a replacement cost basis.

Two other components of total profits—earnings of the Federal Reserve System and profits of foreign subsidiaries of American companies—are likely to be considerably less impressive. Earnings of the Federal Reserve are likely to fall because of lower average yields on the $145-billion holdings of U.S. Treasury securities. Earnings of foreign subsidiaries of American corporations are expected to rise about in line with domestic earnings.

Publicly reported gains in earnings will be somewhat smaller because they reflect accounting conventions that are different from those used in calculating economic profits. The two most important differences are the inclusion of inventory profits in some corporate reports and the general use of historical cost depreciation. While inventory profits will make little difference to the growth of reported profits in 1983 (because low inflation should keep inventory profits at the low levels reached last year), the use of historical cost depreciation will reduce the reported profit gain because historical cost depreciation responds more slowly to a deceleration in the cost of capital goods.

But even taking into consideration such accounting and coverage differences, publicly reported net corporate earnings will rise strongly. For example, earnings per share for the 500 companies covered in the index calculated by Standard & Poors should show a 25% gain this year. Whatever the accounting method, thus, profits are in the midst of a healthy rise that should carry through 1983.

Economy Watch

CONTRARY to earlier fears, the recovery shows no sign of stalling. Private nonfarm employment grew in April at an annual rate of 3.0% from its first-quarter average, as compared with less than 1% in the first quarter. And the workweek continued to lengthen. As the recovery persists, confidence naturally is building. Consumer surveys, for example, have shown sharply improving sentiment for three straight months. Business confidence readings also have strengthened. Moreover, capital investment activity has held up better during recent months than generally had been expected. And in Europe, encouragingly, several countries are showing incipient signs of cyclical upswing.

Meanwhile, apprehension about a turn toward tightening by the Federal Reserve has disappeared as the growth of the monetary aggregates has slowed. Indeed, debt-market sentiment has become increasingly positive as a substantial and growing volume of securities has been marketed at declining yields

All of these developments are contributing to the expectation that the U.S. recovery will carry through at least into summer. An added lift for the economy is in store July 1 when the final stage of the three-year tax cut adds $38 billion, at an annual rate, to disposable income.

The overhang of problems (budget stalemate, financial weakness in key developing nations, an overvalued dollar) could still derail expansion later on. But nearly all analysts are heartened at prospects for the months just ahead.

Inventory uplift

The Morgan Bank's estimate of real GNP in the first half is essentially unchanged from a month ago. The current quarter's growth rate, however, has been boosted almost two percentage points to 4.7% (table on this page). This mainly reflects greater potential for stepped-up production of nonauto goods, following the sharper-than-expected drawdown in nonauto inventories in the first quarter. That was the main reason real GNP growth turned out to be significantly lower than expected in the first three months of the year. The decline in nonauto inventories in the first quarter, in fact, was almost as large as the record-setting drop in last year's fourth quarter.

Inventory-sales ratios have fallen sharply in many lines, and business is unlikely to allow this to continue. This does not mean that in-

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1982	*1983*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−1.0	3.1	4.7	4.9	4.6
Real consumer spending	4.5	2.3	3.1	4.6	4.4
Real business-capital outlays	−6.0	2.8	−1.2	2.3	4.2
GNP deflator	3.7	5.8	4.7	3.9	4.4
Consumer prices	2.0	−0.7	5.1	5.1	4.7
Real disposable personal income	0.3	1.8	3.0	6.8	4.9
Saving rate (%)	6.0	5.9	5.8	6.3	6.4
Housing starts (Millions)	1.3	1.7	1.7	1.7	1.7
Auto sales (Millions)	8.7	8.4	8.8	8.9	9.1
Unemployment rate (%)	10.5	10.2	10.1	10.1	9.9

Note: 1982 Q4 and 1983 Q1 data are actual.

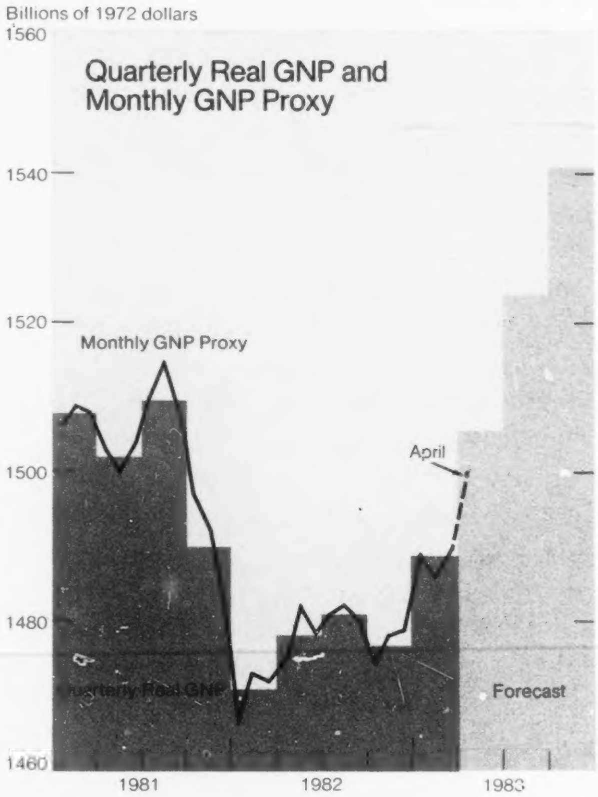
ventories of nonauto goods are apt to increase appreciably in the near term. But it does mean that output probably will not continue to be held back by large inventory drawdowns. In the second quarter, a swing in nonauto inventories could help boost overall output in much the same way as the swing in auto inventories did in the first quarter.

The surprising strength of business investment is another encouraging element in the near-term outlook. Real spending on plant and equipment rose at an annual rate of almost 3% in the first quarter; the usual pattern in the early stages of a recovery is continued slippage.

No one expects a near-term boom in business investment. Indeed, broad leading indicators fail to point to much, if any, real increase in plant-and-equipment outlays in the current quarter. But in the second half of the year, support for cyclical growth from investment activity seems likely. Among the reasons: continued strength in such key components of investment activity as office and store equipment; growing confidence in the longevity of the recovery; the upsurge in profits (story on page 1); and lower funding costs coming from the rise in equity prices.

Inflation blip

The generally favorable economic readings expected for the months ahead are likely to be accompanied by a temporary surge in the price indexes. These will pick up the April increase in gasoline excise taxes and the recent firming in oil-product prices, plus pressures on food prices arising from weather-damaged crops of fruits and vegtables. The consumer price index (CPI) for April, for example, could show an increase close to a double-digit rate.



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

Still, underlying cost and price pressures remain quite moderate. An especially promising sign was the decline in first-year wages negotiated under major collective bargaining agreements in the first quarter, the first decline in the 15-year history of the series. While this came about largely because of the steel-industry contract, continued slippage generally in the rate of wage increase points to further reductions in cost pressures.

Against this background, financial-market participants presumably will discount the upcoming blip in the price indexes. And a temporary uptick in inflation should not seriously affect consumer and business sentiment. Price performance this year stands to be the best in more than a decade. The CPI is expected to rise only 3.3% this year compared with increases of 6.2% in 1982 and 10.4% in 1981.

Business Borrowing: No Surge Ahead

BUSINESS credit demand is likely to grow only modestly in the months ahead—falling far short of the pace of earlier recoveries.

In the first four months of this year, short-term business borrowing (commercial and industrial bank loans and nonfinancial commercial paper) actually fell 1% below its depressed reading at the turn of the year. Despite that sluggish performance, some analysts are voicing concern that business credit demands, coming on top of massive borrowings by the U.S. Treasury, could create pressures in credit markets in coming months.

Such fears appear unwarranted. A dramatic rise in corporate profits (story on page 1), continued inventory liquidation, and small increases in prospect for business investment add up to decidedly modest needs for new external financing. Corporations, moreover, have begun to restructure their balance sheets. They are reducing their dependence on short-term debt and taking advantage of a favorable stock market to replace debt with equity. In this setting, business credit extensions seem likely to rise even less than the modest gains projected by The Morgan Bank in January.*

"Gap" analysis

A good proxy for corporations' external financing needs is the difference between their spending on inventories and fixed investment and their retained cash flow.** This financing "gap" declined dramatically at the end of 1982 (chart on page 8), reflecting massive inventory liquidation. From that point to the end of 1983, the gap is expected to grow by about $28 billion. That rise, significantly, is smaller in relation to the size of the economy than in any postwar recovery.

A major reason for this is that business fixed investment is expected to rise only half as rapidly over 1983 as a whole as during the first year of the typical postwar recovery. In addition, inventory stocks are likely to fall about half a percent—in contrast to a rise of nearly 1% in the first year of a typical recovery.

Retained cash flow, in the meantime, will be boosted by a rise of more than 30% in pretax corporate profits in 1983. This will result in part from a pickup in business coupled with improved productivity and the lowest increase in wage rates in 17 years. Too, lower interest rates will enable firms to reduce debt-service costs. And the declines that have occurred in capital-goods prices will contribute to moderation of nonlabor costs.

Retained cash flow also will be bolstered this year because corporate tax payments—on a cash basis—are likely to be some $13 billion lower than in 1982. In part, this reflects overpayment of taxes in 1982. Overpayments occurred because corporations, having little experience with the tax cuts enacted in 1981, overestimated their 1982 tax liabilities.

The 1982 overpayments are resulting in larger refunds this year than last. The result: Corporate tax payments net of refunds were $7 billion lower in the first quarter of 1983 than in the same period last year.

In contrast with last year's overpayments, quarterly tax payments this year are likely to lag behind the pickup in profits. The main reason is that quarterly declarations—based on es-

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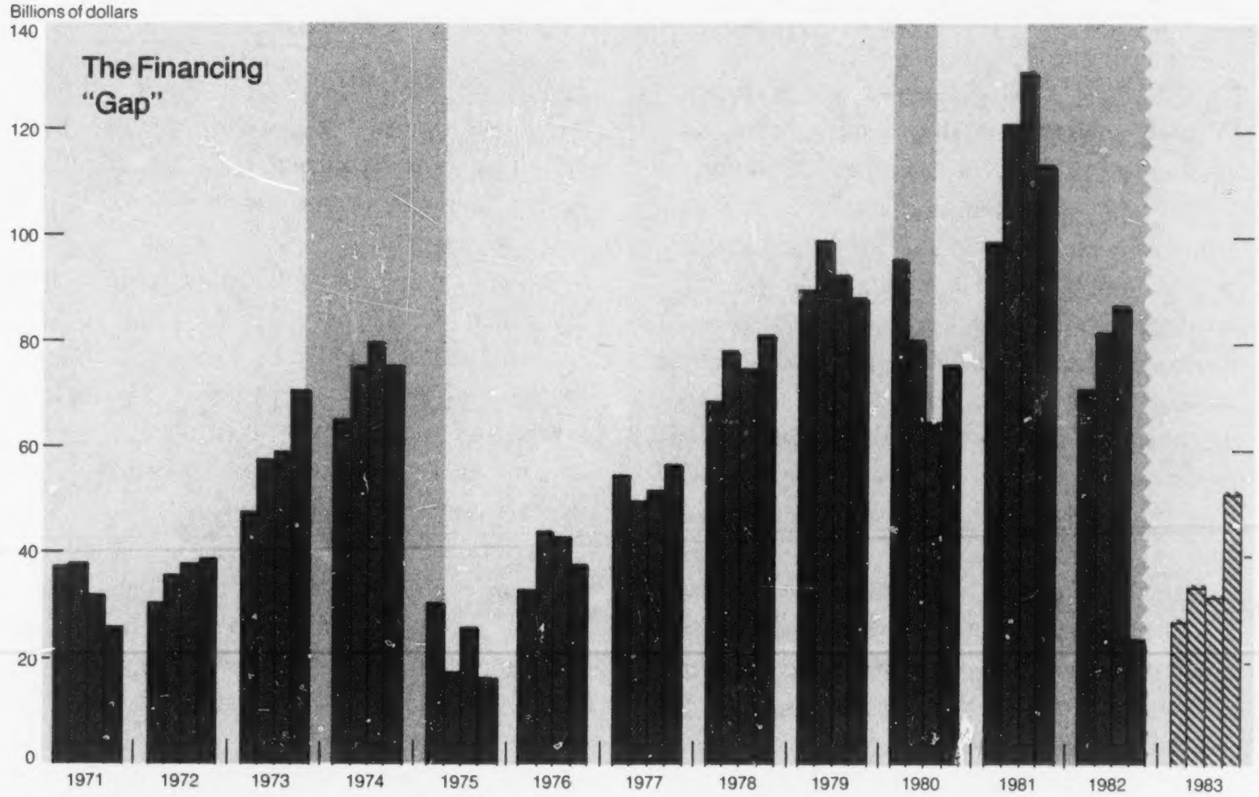
*"Credit Markets in 1983," *The Morgan Guaranty Survey,* January 1983.

**Retained cash flow is defined here as pretax corporate profits excluding inventory valuation adjustment, less corporate tax liabilities and dividends.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981 whose terminal date remains open.

timates of taxable income—will be made before the actual rise in profits is fully known.

Altogether, the financing gap for calendar 1983 is expected to be only about half as large as it was last year.

Shifts in the mix

A rise in bond issuance is expected as firms give top priority to strengthening their balance sheets. Whereas at the trough of the 1973-75 recession the short-term debt of nonfinancial corporations amounted to just over 42% of their outstanding debt, the comparable ratio stood at just under 48% at the end of 1982 —widely thought to be the trough of the recession just past. Firms are concerned about maintaining such a large fraction of debt in short maturities, because a rise in short-term interest rates would leave them vulnerable to much higher debt-service costs.

In the first two months of this year, bond issuance was far below the rate needed to make a significant dent in the short-term debt burden. Many corporations evidently were waiting for further declines in bond yields before getting locked into long-term financing costs.

In March and April, however, public bond issuance surged to a monthly average of $5.6 billion—75% above the average in the first two months.* During the rest of the year, issues are expected to average some $4.8 billion a month. For the year as a whole, issuance will likely be 60% higher than last year.

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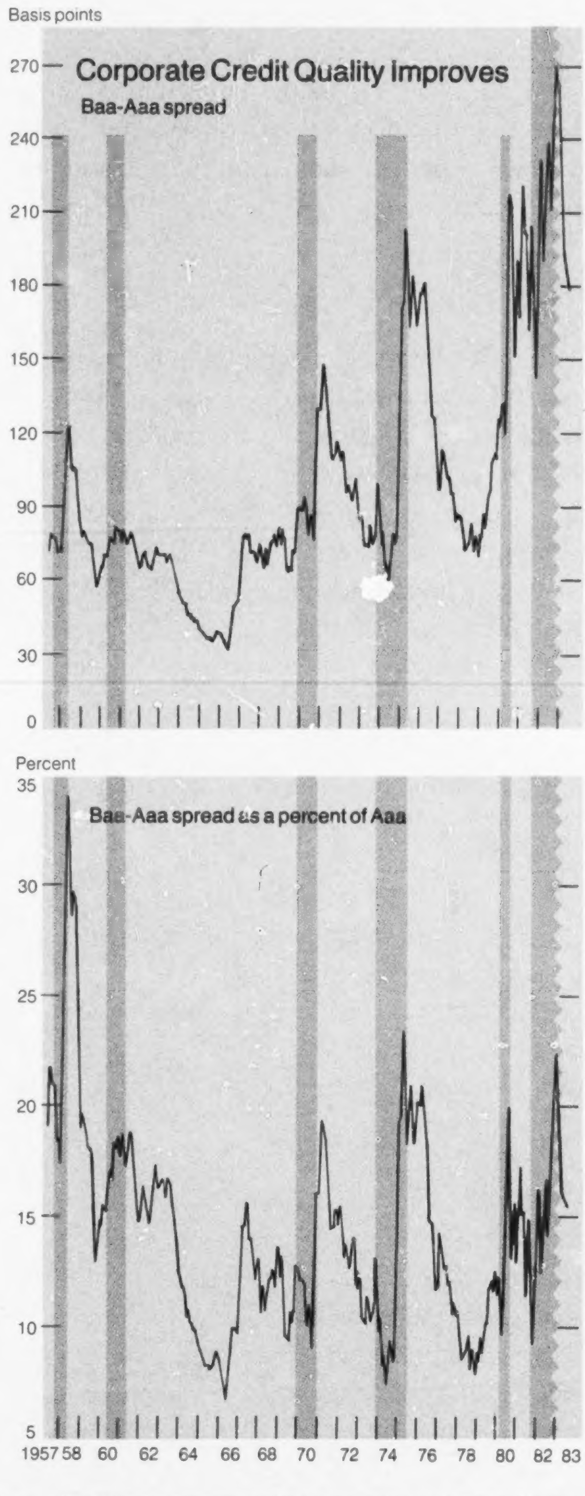
*The $5.6-billion figure represents public bond issuance by all corporations. Financial corporations issued an average of $1.8 billion in March and April—up 43% from the January-February average. Issues by nonfinancial corporations averaged $3.8 billion in March and April, 97% above the January-February level.

The stepped-up activity reflects recent declines in long-term corporate bond yields (at the end of April Aaa yields were 65 basis points lower than the February average) and a growing perception that further declines this year are likely to be modest. For many firms the need to refinance some short-term debt outweighs potential gains from waiting. At the same time, investors are receptive to still-handsome coupon returns.

Further stimulus to bond activity has come from improved access to the markets by firms without high credit ratings. Such firms were deterred throughout last year from issuing long-term debt by wide "spreads" between the yields of lower-quality and higher-quality issues. Such spreads, however, have declined. As the upper panel of the chart on this page shows, the yield differential between Aaa and Baa rated debt dropped 91 basis points between September 1982 and April 1983. Even with the drop, the differential in April (178 basis points) ordinarily would be a major deterrent to the issuance of lower-quality debt. But, as shown in the lower panel of the chart, quality spreads, in relation to the level of interest rates, are less of an obstacle to bond issues now than they were in the spring of 1976 when bond markets erupted with new issues. Awareness that credit quality is improving, together with expectations that it will continue to do so as business recovery proceeds, has helped lower-rated firms lengthen their debt maturities. In the first four months of 1983, issues rated Ba or lower amounted to 24.5% of all new debt issues, compared with 12% in 1982 as a whole.

The increased issuance by lower-rated companies is also attributable in part to the use of


Corporate Credit Quality Improves

Baa-Aaa spread

Baa-Aaa spread as a percent of Aaa

Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981 whose terminal date remains open.

convertible bonds, which may represent the only access that such firms (often sound but little known) have to the bond market. In the first four months of this year, convertible issues, at $3.4 billion, amounted to 19% of total new debt–compared with 14% over all of 1982.

Equity activity

Besides spurring convertible bond issues, the rising stock market has encouraged a spurt of common-stock issues. New issues totaled $5.8 billion in March–137% above the monthly average in the fourth quarter of last year.* (Initial public offerings–new issues by firms "going public"–hit a record $2 billion in the first quarter of this year.)

The high volume of new equity issues has enabled many firms to begin reducing their debt load, which had risen to 38% of total assets last year from 28% ten years ago. A rising debt burden may seem attractive in inflationary times, when repayment can be made with cheaper dollars. But high debt-equity ratios are more costly in the current climate of disinflation.

Investors, meanwhile, are flocking to the stock market. Mutual funds, swollen by inflows into IRA and Keogh accounts, once again have become a major channel through which small investors are acquiring equity portfolios. Altogether, mutual funds chalked up a $5-billion inflow in the first three months of this year. Institutional investors, for their part, have increased the share of equities in their portfolios in recent months. That share, however, remains well below the level a decade ago. Institutional portfolio managers thus still have large scope for additional investment in stocks.

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*The $5.8 billion includes $1.2 billion of AT&T issues. Even apart from those issues, volume in March was 89% above the monthly average in the fourth quarter.

The Miniboom in Housing

HOUSING activity is shaping up as the star performer in the recovery. Residential construction put in place accounted for more than half of the growth in real GNP this past quarter. And, with starts having risen 34% from their fourth-quarter average, every indication is that homebuilding outlays will continue to spur expansion for some time to come.

Builders of single-family homes apparently are encouraged by prospects for the spring selling season. Sales of new homes continued to rise at a brisk pace in the first quarter (up 14% from the fourth quarter of last year). Inventories of unsold homes, despite the sharply higher production rates of recent months, are the lowest in more than a decade. The average time between a start and a sale, moreover, has shrunk dramatically from six months a year ago to three months today. Finally, prices of new homes have moved up rapidly in the past few quarters, reflecting a change in the mix of homes sold toward larger and better equipped houses as well as stronger housing markets.

Owners of rental properties, at the same time, are seeing a turn for the better in the relationship between rent receipts and operating costs—a relationship that had deteriorated for many years. This may be a key reason why starts of multifamily units, as well as of single-family homes, have registered impressive gains. In total, starts reached an annual rate of almost 1.7 million units this past quarter, topping what even the most optimistic analysts had expected for late in the year.

Why the growing optimism over the housing outlook? The chief reason—apart from the surprising strength of the recent data—is the sheer size of the potential market in a climate of improving financial and economic conditions.

Household formations slowed dramatically in recent years, reflecting not only prohibitively high mortgage rates but also rising joblessness and deteriorating job prospects. In fact, had the pattern of household formations of the 1960s and 1970s continued into the 1980s, approximately 1 million more new households would have been formed during the past few years. That would have been the case had "headship rates" (the ratio of the number of heads of households to the number of adults in each age group) continued to move up as they did during the 1960s and 1970s.

Significantly, the falloff in household formations occurred largely among those between 20 and 30 years of age—the age group that has the greatest impact on growth of the housing stock. That group has been out of the market for a long time—doubling up with others or remaining in family "nests." But in an improving financial and economic climate, that can be expected to change.

Not all of those that have been out of the housing market will have the ability to form a new household. But even if only one in four does so in the next year, this plus the normal growth of households (an estimated 1.6 million to 1.7 million) would suggest new-production needs, including mobile homes, that could easily approach 2 million units this year.* And assuming continued economic recovery, many of

(Continued on page 14)

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*A full assessment of needs must take into account the number of dwellings likely to be removed from the housing stock (owing to demolitions, fires, and floods). It also must reckon with the number likely to be added as a result of rehabilitations and conversions from other uses. In recent years, removals and additions have tended to be offsetting. Thus the number of new housing units—including mobile homes—added to the housing stock almost entirely has reflected growth in the number of households.

HOME-FINANCING'S NEW FACE

HOME-FINANCE patterns have changed markedly since the mid-1970s, reflecting the growth of a nationwide market for securities backed by pools of mortgages issued or guaranteed by a federal or federally sponsored agency.* Such securities have brought new investors such as pension funds into the home-mortgage market—investors that previously had been unable to participate because of the market's fragmented and local character.

Mortgage-backed securities also have brought about revolutionary change in the role of traditional mortgage-buying institutions such as savings and loan associations (S&Ls). Some of them, by buying mortgage-backed securities rather than primary mortgages, have come to participate in mortgage markets in the same way as pension funds. Thus they have lost their character as strictly local lenders. Other S&Ls, by selling off their loans to pools and retaining only a servicing function, have become more like mortgage bankers.

The growing role of mortgage-backed securities is dramatically illustrated by the fact that about three-quarters of the increase last year in home-mortgage debt outstanding was provided by investors in mortgage pools (accompanying chart).** Thrift institutions, which a few years ago had provided funds for roughly half of all home-mortgage credit extensions, reduced their holdings of primary mortgages. Their sales in the secondary market swamped net new loans closed.

Contributing to the growing popularity of mortgage-backed securities have been inducements to primary mortgage holders (such as thrift institutions) to convert their seasoned low-yielding loans into the new mortgage instruments. For example, the Federal Home Loan Mortgage Corporation (Freddie Mac), a private corporation within the home loan bank system, introduced its "guarantor" program in late 1981. That invited lenders simultaneously to sell seasoned loans and buy "participation certificates" representing undivided interest in those same mortgages. Such "swaps"—amounting to $20 billion last year—boosted liquidity because the certificates were part of a broad secondary market and thus, unlike primary mortgages, could be sold readily to finance new mortgage commitments. An added advantage was that Freddie-Mac certificates, also unlike primary mortgages, could be used as collateral for short-term borrowings under repurchase agreements.*

A swaps program with similar features also was introduced late in 1981 by the Federal National Mortgage Association (Fannie Mae), another federally sponsored but privately owned agency. Last year, over $14 billion of mortgage-backed securities were issued by Fannie Mae, most of them as direct swaps. This altered Fannie Mae's role in the secondary market considerably. Previously, it had limited itself to buying whole loans, funding them primarily with short-term debt. That strategy had produced the same kind of mismatch between assets and liabilities that bedeviled thrift institutions during the past several years of high interest rates. Fannie Mae now can count on a steady source of

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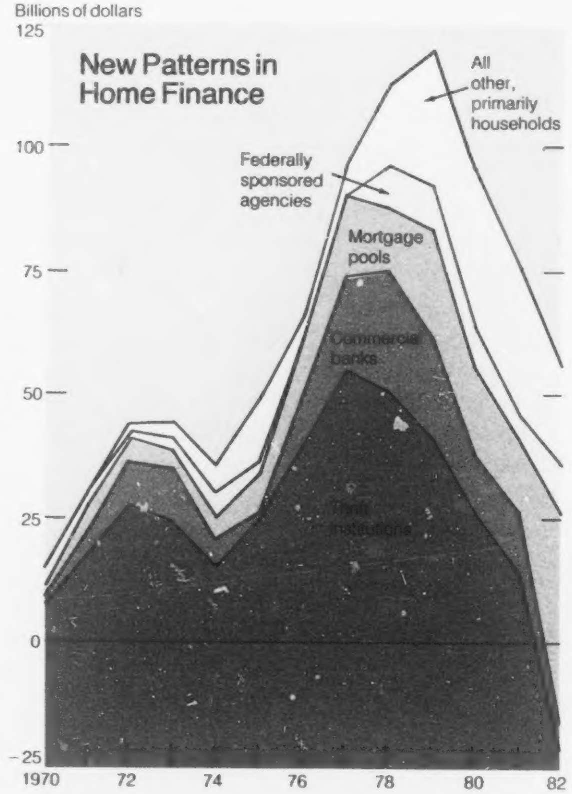
*Most such securities are of the "pass-through" variety; that is, they pass through both principal and interest monthly to the owner of the securities. Mortgage-backed bond-type securities—which provide for annual principal payments and semi-annual interest payments—are a relatively small share of the market.

**The household sector was another important source of home-mortgage credit extensions. Householders accounted for about 20% of the total—a figure that reflects seller-financing, often at concessionary rates, needed in many cases to sell a house.

*Under repurchase agreements, the collateral in effect is purchased by the lender and is "repurchased" by the borrower at maturity, typically a few days or a few weeks later. Such borrowings have become an important supplementary source of funds for thrift institutions, enabling them to fund their assets smoothly at times of volatility in deposit flows. S&Ls relied heavily on repurchase agreements in October and November of last year, for example—borrowing $5 billion to bridge the gap between maturing All Savers Certificates and newly opened Money Market Deposit Accounts.



New Patterns in Home Finance

Note: Plottings represent cumulative net changes in holdings of mortgages on one- to four-family houses.

fee income as an issuer of mortgage-backed securities. It can avoid the interest-rate risk it had previously been assuming and, at the same time, meet its statutory obligation of providing liquidity to the home-mortgage market.

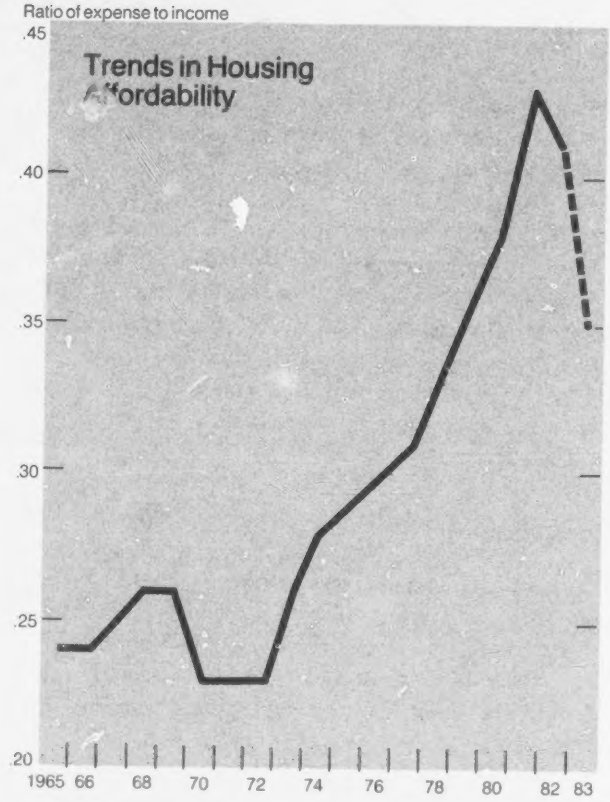
Accounting-rule changes authorized in 1981 by the Federal Home Loan Bank Board are another explanation for the boom in mortgage-backed securities. Under the new rules, it became easier for S&Ls to sell depreciated assets such as seasoned low-yielding mortgages. If the resulting mortgage-backed security were retained in an S&L's portfolio, no loss needed to be shown on the income statement. If the security itself were sold, losses could be reflected in income statements over the life of the mortgages themselves rather than just in the year of sale as required by the old rules.

With enlarged incentives for use of mortgage-backed securities, volume rose to a high of $175 billion at the end of last year (including a small amount of mortgages on apartment buildings) —an increase of almost $50 billion from the year-end 1981 level. Fannie-Mae and Freddie-Mac securities together accounted for most of that growth, although measured by outstandings the mortgage pools guaranteed by the Government National Mortgage Association (Ginnie Mae), part of the Department of Housing and Urban Development, continued to dominate the secondary mortgage market.

Investor groups

Detailed data on the ownership of the securities issued or guaranteed by the three agencies are not available—since a large part (roughly one-third in the case of Ginnie-Mae securities) is held in the name of nominees. The major investors seem to be thrift institutions which hold about 40% of those Ginnie-Mae securities not held by nominees. Roughly the same proportion of the Fannie Maes is owned by thrift institutions. Pension funds also figure prominently, holding about 35% of Fannie-Mae securities and 15% of nonnominee Ginnie Maes. But the range of nontraditional mortgage-market investors is quite broad—including insurance companies (which until the advent of mortgage-backed securities had withdrawn almost entirely from the home-mortgage market), individuals, and corporations.

Mortgage-backed securities are unlikely to continue to grow at last year's heady pace. The volume of swaps executed in the past few months, in particular, is down sharply. This is because of reduced need for liquidity by S&Ls which recently have seen very rapid growth in deposits, particularly in Money Market Deposit Accounts. Still, the broad appeal of mortgage-backed securities, especially to pension funds with their $800-billion reservoir of capital, points to continued growth and to an increasingly important role in financing homebuilding.



Note: Plottings represent percent of median family income, before taxes, needed to carry median-priced new house and to cover basic home owner expenses such as real-estate taxes and insurance which typically equal 2 1/2% of the market cost of a house. The key premise of the 1983 estimate is that mortgage rates average 12 1/2% during the year.

the rest of the "lost" households of the early 1980s would be in a position to augment demand for years to come.

How much of the potential market is translated into effective demand hinges critically on affordability. Unquestionably, housing today is costly relative to what it was in the 1960s and 1970s. Rents have not risen relative to average income, nor has the median price of a new house. However, carrying charges on the typical mortgage grew sevenfold between the mid-1960s and 1982 as mortgage rates rose steadily to record highs. Significantly, carrying charges increased at twice the rate of median family income.

All in (principal, interest, taxes, and other basic home-owner expenses such as property insurance), the typical home buyer in the 1960s and early 1970s faced annual housing expenses equal to about 25% of median family income before taxes. In 1981 and 1982, that ratio was above 40% (chart on this page).

Greater affordability

This year, however, the ratio of expense to income is dropping to an estimated 35%. This suggests that an increasing number of families can qualify for a housing loan.

Late last spring, when mortgage commitment rates nationwide were at a peak of 17%, only an estimated 15% of all U.S. households had enough income to qualify for the typical mortgage. This assumes that lenders observed the traditional rule-of-thumb that mortgage payments (plus the basics like taxes and insurance) not exceed 25% of household income. Even under a less strict rule which has become more prevalent–say, 30% of income devoted to housing costs–only 20% of all households qualified on income grounds.

Comparable calculations today–with mortgage commitment rates in the neighborhood of 13%–point to affordability for 20% of all households using the 25% expense rule; for 30%, using the 30% rule. Under the 25% rule, for example, qualifying income for a mortgage on a median-priced house is now about $37,000 a year, compared with $43,000 last spring. The drop has brought several million households into the ranks of those who theoretically can afford to buy.

Only a small fraction of these probably would want a house. But it would take only a small fraction–on top of those who had previously qualified for mortgage credit–to create substantial demand for home ownership. This, at least, is suggested by the experience of the Federal Housing Administration (FHA). That agency saw a marked increase late last year both in mortgage applications and in its share of total mortgage originations. FHA rates tended to be slightly below conventional rates at the time, but only small differences were very significant in bringing about a pickup in demand for FHA mortgages.

Newly qualified buyers, of course, may choose to wait–hoping that interest rates will drop significantly further–before deciding to buy. The past several years, however, have conditioned many prospective buyers to high housing costs; few, if any, expect a return any time soon to the comparatively low housing costs of the 1960s and 1970s. In any case, potential home buyers who expect interest rates to decline can act on that judgment now by financing the purchase of a house with a variable-rate mortgage. The inducement to buy now is the avoidance of further rises in home prices that may occur as demand continues to pick up.

It is striking, however, that about two-thirds of home mortgages now being generated are fixed-rate. While this undoubtedly reflects a concern about future increases in mortgage rates (and concomitant increases in mortgage payments), it also testifies to buyers' tolerance of mortgage rates that only a few years ago would have been viewed as intolerably high.

All in all, changing attitudes about housing costs, improved affordability for many, and pent-up demand argue for a miniboom in housing production for some time to come. Obviously, the investment motive for home ownership, which had a lot to do with making the 1970s a roaring boom time for housing, has been blunted as inflation has come down and real estate values have stopped soaring. But shelter needs are large, and financing those needs is becoming less difficult.

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Economic Outlook. *The recovery is showing surprising vigor. Real GNP growth this quarter is expected to top 6%. As the pace quickens, new concerns about M1 arise. Interest rates have firmed. Latest quarterly projections.* 1

Money Harvest. *The new PIK program for farmers (giving them grain for taking land out of production) is stirring controversy. Farm suppliers will feel its effects. So will GNP.* 4

Deregulation. *Impressive gains have been made in thinning the regulatory thicket. But Washington's ardor seems to have waned. The implications for business and consumers.* 7

Monetary Indicators 11

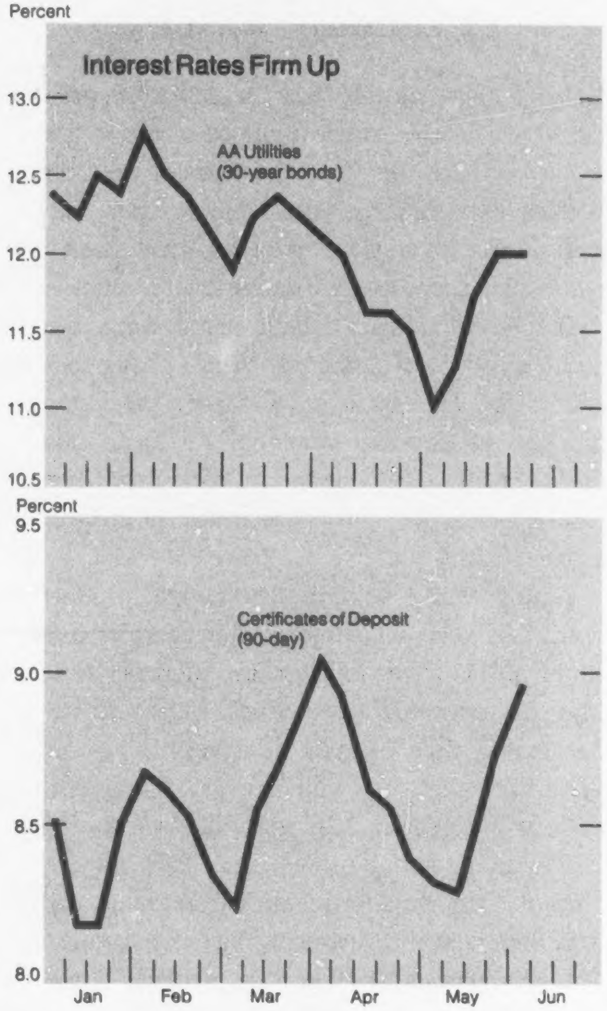
Economy Watch

THE past month has revealed surprising vigor in the recovery. It also has brought a marked shift in financial-market sentiment. Earlier expectations that interest rates would drift lower during the summer have been replaced by feelings that rates could move up.

Increased yields on debt instruments of all maturities have reflected these changed expectations. For example, yields on 90-day certificates of deposit were up 75 basis points during May, and yields on long-term bonds rose by nearly a full percentage point (chart on next page).

A key factor behind the change in market sentiment was the surge in the narrow money supply–M1. The $15 billion increase during May disappointed hopes that M1 would move back toward the Federal Reserve's target range. With the latest rise, which reversed a declining pattern in April, M1 growth has averaged 13% (at an annual rate) since last July. Admittedly, financial innovations (such as NOW and Super-NOW accounts) have distorted the M1 numbers. Moreover, the Federal Reserve has explicitly downgraded the importance of M1 in monetary-policy formulation. Even so, financial-market participants have become increasingly unwilling to ignore growth in M1 that is far out of line with the Fed's 4%-to-8% target range for this year, a range that was raised to take those distortions into account.

Above-target money growth has become harder to ignore as the recovery has taken on a new robustness. For example, payroll employment since December has climbed by an impressive 900,000. And industrial production, which was up by 2.1% in April alone, now looks as if it will increase at more than a 15% annual rate in the second quarter. As a



Note: Plottings are weekly averages; latest plotting is June 3.

result of this and other evidence, The Morgan Bank has raised its estimate of second-quarter real GNP growth (a 4.7% rise was foreseen last month) to 6% at an annual rate (table on this page). Such growth, if realized, would compare with a 2.5% real-GNP rise at an annual rate in the first quarter.

Behind the rise

About half of the expected second-quarter GNP growth would be the result of a slowing in the rate of decline in business inventories. Significantly, however, final demand seems to be quickening. Spending on business equipment, which had been expected to be a drag on the economy this year, made a surprisingly strong showing in the first quarter. And every indication is that a vigorous growth pace is being maintained. Orders for nondefense capital goods rose 12% in April, after a 5% increase in March. And shipments in April were 3.4% above their first-quarter average.

Strengthening in consumer spending is also evident. The index of consumer sentiment, published by the University of Michigan, jumped a record eight points in April and has come up by close to 20 points in the past three months to its highest level since 1977. Tending to confirm the improvement in sentiment was a favor-

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

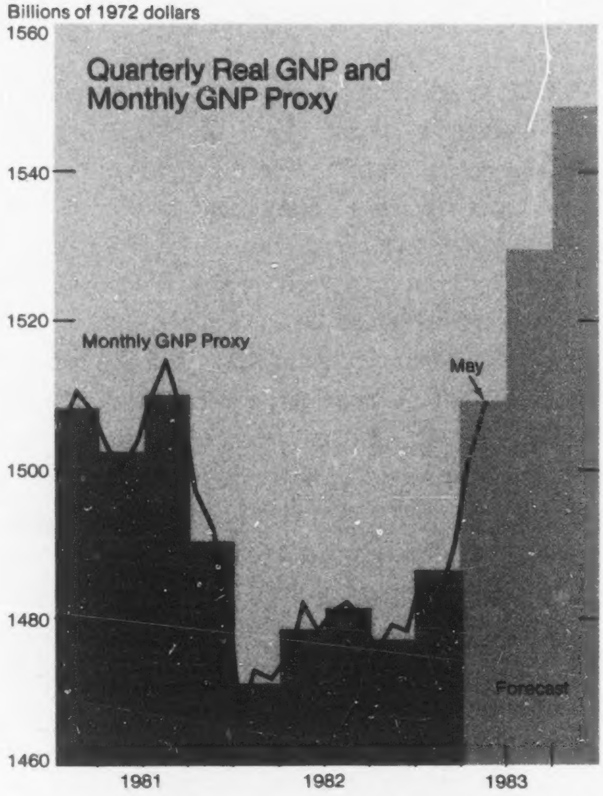
	1982	*1983*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−1.0	2.5	6.1	5.6	5.1
Real consumer spending	4.5	2.6	4.2	5.5	4.9
Real business-capital outlays	−6.0	5.6	2.2	3.1	3.7
GNP deflator	3.7	5.7	4.3	4.2	4.3
Consumer prices	2.0	−0.4	4.4	5.5	4.8
Real disposable personal income	0.3	2.1	3.3	10.4	4.5
Saving rate (%)	6.0	5.9	5.7	6.7	6.6
Housing starts (Millions)	1.3	1.7	1.7	1.7	1.7
Auto sales (Millions)	8.7	8.4	8.8	9.2	9.5
Unemployment rate (%)	10.7	10.4	10.2	10.1	9.9

Note: 1982 Q4 and 1983 Q1 data are actual.

able reading for May from the nation's largest retailers and a pickup in auto sales to an annual rate of 8.9 million units from an average of 8.4 million in the first four months of the year.

These indications of stepped-up final demand do not apply to all sectors. For example, nonresidential construction activity is still declining. Moreover, the trade sector continues to act as a drag on domestic activity: Exports in April were off more than 10% from a year ago, and imports are now beginning to rise as businesses and consumers step up their spending.

On balance, however, the economy is stronger than was generally anticipated only a month ago. Given the present upward momentum and the $38-billion stimulus (at an annual rate) to consumer purchasing power due in July from the tax cut, second-half expansion seems virtually assured.



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

Constraints on the Fed

The sharp and continuing uptrend in M1 is a concern to financial markets because it raises the possibility that the Federal Reserve may tighten monetary policy. Arguing for such an action is the worry that inflation expectations may be rekindled if money-supply growth remains unchecked in an environment of strong economic growth.

The case for applying restraint, however, is far from clear-cut. Cautioning the Federal Reserve against a tightening move is the fact that growth in the two broader monetary aggregates–M2 and M3–generally has been in line with their targets (chart on page 11). International concerns are an added constraint. Any upward move in interest rates is likely to add to the exchange value of a dollar that is severely impairing U.S. trade performance. In addition, a rise in interest rates would exacerbate international debt problems.

Unless money-supply growth and the rate of economic expansion slow significantly, a tightening move by the Federal Reserve will become increasingly likely. Any policy response by the Fed, however, is likely to be measured.

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Harvesting Nothing But Money

THE farm economy has been in a severe recession in recent years. Bankruptcies are the highest in decades. The delinquency rate on farm mortgages has more than doubled in the past five years. Record harvests and weak demand for food and feed grains have resulted in overflowing grain bins and depressed farm prices. Real farm income (net*) in 1982 totaled about $7 billion, the lowest since the 1930s.

President Reagan, concerned about the economic crunch on the nation's farms, has come up with a new program to ease the farmers' plight. It's PIK–payment-in-kind. Under the plan, put into effect in mid-March, the federal government will give surplus grain to farmers who take land out of production.

Already the program has become controversial. Critics contend that farmers will receive a windfall for growing nothing (the average PIK payment is estimated at almost $8,000). And one opponent of PIK has characterized the program as "socially inappropriate, financially ineffective, and economically inefficient." Moreover, the program is expected to have an adverse effect on many farm-supply businesses such as fertilizer, seed, pesticides, and farm equipment. Finally, as the effects of the program work through the farm economy the result will be to dampen the level and growth rate of real GNP in the months ahead.

How PIK works

PIK is not a new idea. In 1933, the Roosevelt Administration asked cotton producers to reduce their acreage in exchange for either cash or government-held cotton. In the 1960s, a small payment-in-kind program was implemented to reduce surplus feed grain.

The new program is much broader in scope and size than its predecessors. Farmers who agree to idle part of their acreage will receive –at no cost to them–some of the surplus grain they had pledged as collateral for federal price-support loans.* Farmers with no loans outstanding will have crops given to them from the government grain reserve.

The response of farmers to the program has exceeded Administration expectations. The Secretary of Agriculture originally estimated that PIK would idle about 23 million acres over and above the land already taken out of production by the existing acreage-reduction program. The actual figure is likely to be closer to 55 million acres–almost 2½ times the initial projection. The Agriculture Department estimates that this cutback will reduce wheat production by 20% and corn production by 30%. This will mean that government spending on loans, storage, and price supports is likely to fall roughly $1 billion this year and $5 billion in fiscal 1984 below the levels that would have occurred in the absence of PIK.

These reductions, however, will be offset by the hidden costs of PIK. Losses, for example, will occur as grains are turned back to farmers and their previous price-support loans are written off. The losses from these forgiven loans and from the forgone interest are expected to total $12 billion in fiscal years 1983 and 1984.

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*Gross farm income less production expenses and changes in the value of inventories divided by the consumer-price index.

*Before each planting season, the Secretary of Agriculture announces a "loan rate" for each commodity–that is, the price at which the Commodity Credit Corporation (CCC) values the crop. If farmers find that market prices are low after harvest, they can place their crops in storage and use the commodity as collateral for a CCC loan. The CCC "loan" can become a cash payment if farmers default on their "loans" and surrender their crops to the government.

PIK and the GNP

The payment-in-kind program will have a substantial impact on GNP this year. Sales of farm implements and materials will decline as a result of PIK. More important will be a 10% drop in farm output as measured in constant 1972 dollars. The drop in farm output will appear—in the GNP accounts—as a reduction in the consumption and export of farm products or as a reduction in farm inventories (bottom line of table on this page).

The Commerce Department predicts that the PIK program will have its greatest impact on measured output in the fourth quarter of this year when some $15 billion (annual rate) in crops is expected to be returned to farmers. As a result, PIK should reduce the growth of real GNP (annual rate) over the four quarters of this year by about 0.5 percentage points.* A reduction of this magnitude, of course, would be beneficial in the long run if it reduced the current overhang of grain stocks.

In addition to its impact on real output, the PIK program will have an effect on the federal sector of the GNP accounts. As grain from government stocks is given to PIK participants, CCC purchases (which are part of nondefense federal spending) will decline. At the same time, subsidy payments—in the accounts—are increased when the title to the crop is transferred to the farmers. Taken together, the decline in CCC inventories and the increase in subsidies are equivalent to assuming that the Agriculture Department gives farmers a cash subsidy and they in turn repay their outstanding loans and receive the crops pledged as collateral.*

As the table above shows, the net effect of these two transactions on the federal deficit (or surplus)—as measured in the national accounts—should be equal to zero, because the

The Economic Effects of PIK

(Billions of dollars at annual rate)

	1983 *Q3*	*1983* *Q4*	*1984* *Q1*	*1984* *Q2*
Budget effect				
CCC (nondefense purchases)	−5	−15	−6	−1
Subsidies	+5	+15	+6	+1
Net change surplus/deficit	0	0	0	0
Inventory effect				
CCC inventories*	−5	−15	−6	−1
Farm inventories (PIK payment)	+5	+15	+6	+1
Net inventory change	0	0	0	0
PIK production effect**				
Farm output***				
Current dollars	−6	−18	−7	−1
Constant 1972 dollars	−3	−8	−3	−0.5

*Corresponds to the decline in nondefense CCC purchases.

**Production effect resulting from reduced acreage under PIK program. This effect will show up as reduced farm inventories, farm exports, or consumption. Production effect is likely to be larger than PIK payment because only 80% of the normal corn yield and 95% of the wheat yield from the idled acres qualifies for the program.

***Some reduction in farm output is likely in the first and second quarters of 1983, as the Department of Commerce seasonally spreads the reduction in farm output from PIK over the four quarters of 1983.

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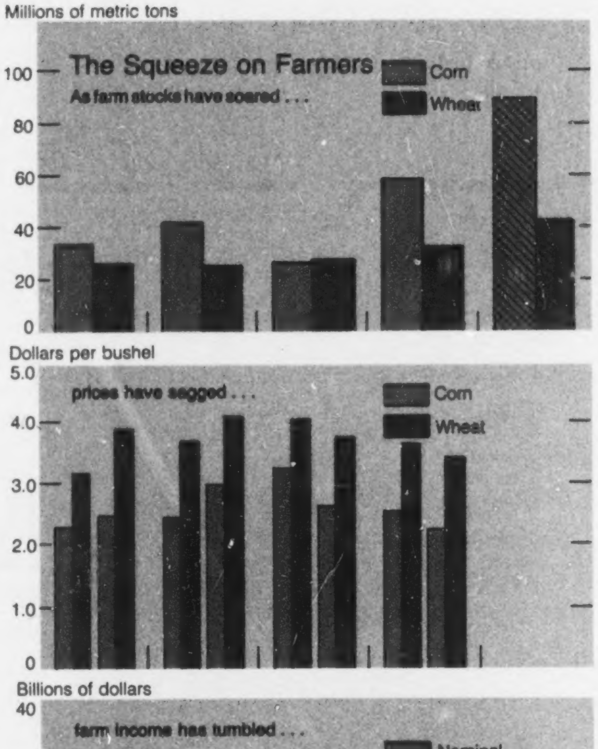
*The production effect is likely to be slightly greater than the PIK payment because only 80% of the normal corn yield and 95% of the wheat yield from the cut in acreage qualify for government crop payments.

*If no loans are outstanding, it is assumed that the farmers use the subsidy to buy the crop directly from the CCC.



Note: Plottings in top panel are for crop years. 1979 corn year: October 1978-September 1979; 1979 wheat year: June 1978-May 1979. Data for 1983 estimated by U.S. Department of Agriculture.

Price plottings in second panel are semiannual averages of monthly data. 1983 prices are not plotted because they begin to show effects of PIK program. In third panel, 1983 data estimated by U.S. Department of Agriculture. In bottom panel, 1983 data estimated by U.S. Office of Management and Budget.

higher subsidies are offset by lower nondefense purchases. Over the longer run, however, the combination of lower production, higher prices, and reduced government grain stocks is expected to result in lower farm subsidies and fewer agricultural price-support loans.

Despite official hopes that PIK will enhance farm prices and income by reducing the large overhang of surplus grain stocks, many agricultural experts believe that PIK could backfire. The reason: Crops returned to farmers under the program are ineligible for further government price supports and thus must be either sold or stored by the farmer. Many fear that these crops will simply be dumped onto the market at harvest time and thus will depress prices. Recognizing this possibility, the Agriculture Department has agreed to pay farmers to store their PIK crops for five to twelve months in order to ease the grain onto the market. Nevertheless, many farmers may decide to sell quickly in order to meet their pressing financial obligations.

Moreover, many farmers may attempt to protect this year's production from price declines or they may bet on future price increases by taking out new CCC loans. This factor, coupled with a near doubling of the number of farmers qualified for price-support loans because of their PIK participation, may result in somewhat higher CCC outlays than projected by the Administration.

All in all, PIK should reduce crop surpluses and increase prices marginally over the next few years. But the problem of excess supplies of food and feed grains is unlikely to go away. The single most important determinant of higher farm income will be an increase in world demand for U.S. grain. That, in turn, will depend most critically on the strength of the global recovery.

Deregulation's Lost Momentum

A reduction in federal regulation is one part of President Reagan's triad to "get government off the backs" of people and business.* The goal, of course, is not to scrap all—or even most—regulations. Officials recognize the need for rules that, for example, protect worker safety and help to insure clean air and water. The focus, instead, is on regulations that are unnecessarily burdensome and add to business and consumer costs beyond the benefits that are achieved.**

After two years, the reform effort has shown considerable progress. The number of pages in the *Federal Register* (where proposed regulations are printed) has been cut by one-third. Federal paperwork requirements for 1981 were reduced by 200 million man-hours. And, by official estimate, reductions in excessive regulation have saved some $10 billion in one-time investment costs for industry as well as $6 billion in annually recurring costs.

In recent months, however, the momentum seems to have slowed. Part of the reason is that the Administration is finding that review of existing regulations is taking more time than expected. Congress, meanwhile, is showing little interest in broad deregulation. The courts, for their part, have blocked several attempts to cut federal rules. And opposition to deregulation—from environmental and consumer groups, unions, business—continues to hinder regulatory reform.

The new Administration moved rapidly from the outset to step up the pace of deregulation.* A Presidential Task Force on Regulatory Relief was appointed, and Vice President Bush was put in charge to give it visibility and stature. The President issued Executive Order 12291, requiring executive branch agencies to introduce cost-benefit analyses of proposed major regulations (those with a cost impact on the economy of $100 million or more). As the months passed, the deregulatory ardor did not wane. The President accelerated the removal of controls on oil and withdrew or modified a score of regulations ranging from passive-restraint requirements for autos and garbage-truck noise standards to strip-mining rules.

Moreover, the Administration has made a concerted effort to reduce both the budgets and the staff levels of the regulatory agencies. The Center for Study of American Business, which closely tracks such efforts, places the high-water mark for federal regulatory effort in the year 1980. By fiscal 1984, the Center estimates that the agencies will have lost roughly one-seventh of their budgets and of their personnel.** Most of the drop took place in 1981-82; the downtrend this year and next is expected to be modest.

Reagan Administration moves to reduce over-regulation follow similar efforts made in the late 1970s. In the case of both the earlier and the more recent efforts, deregulation's effects generally have been positive. Competition has been enhanced and market forces have led to benefits both for industry and consumers. Examples, in brief, of key industries:

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*The other two parts: lower taxes and slower growth in government spending.

**The need for cost-effective regulation has often been the subject of analysis in *The Morgan Guaranty Survey* over the years. Two recent examples: "A New Light on Regulatory Costs," April 1979, and "Renewing Clean Air," September 1981.

*Broadly, government regulation is divided into two categories: economic regulation, which covers market activities such as pricing, entry, and trade practices; and social regulation, which deals with threats to health, safety, and the environment. The former has been reduced in recent years, but the latter has expanded.

**The Center estimates that the spending of 57 regulatory agencies reached a peak of $3.0 billion (measured in 1970 dollars) in fiscal year 1980. By 1984 the spending total is expected to decline to $2.6 billion. Full-time staff positions are seen dropping to 76,400 in 1984 from 90,500 in 1980.

Airlines. The Airline Deregulation Act of 1978 provided for phased-in deregulation. The Civil Aeronautics Board lost its authority over the selection of routes for domestic airlines in 1981, gave up its domestic pricing authority this past January, and will go out of business in 1985.

Between 1978 and 1981 the number of U.S. certificated airlines rose to 86 from the previous 36. The market share of the major trunk lines has declined to 80% from 87% in the past three years. Meanwhile, the market share of local, intrastate, and new airlines has increased to 16.4% from 11.5%. In April 1982, 77% of the domestic coach traffic of the major airlines moved on discount fares, compared with 46% in April 1978.

Deregulation has led to increases in operating efficiency. Airline labor cost increases have slowed as the established airlines have had to control labor costs in order to compete with the new entrants, many of which pay lower wages.

Oil industry. In January 1981 the President ended the petroleum price and allocation controls that had been scheduled to end nine months later. Since full decontrol, consumption of oil in the U.S. has dropped 11% due in part to the sluggish economy but, more importantly, to the adjustment by business and consumers to higher oil prices. Oil imports are down more than a third since early 1981. And market forces are playing a much bigger role in determining energy investment, conservation, and consumption.

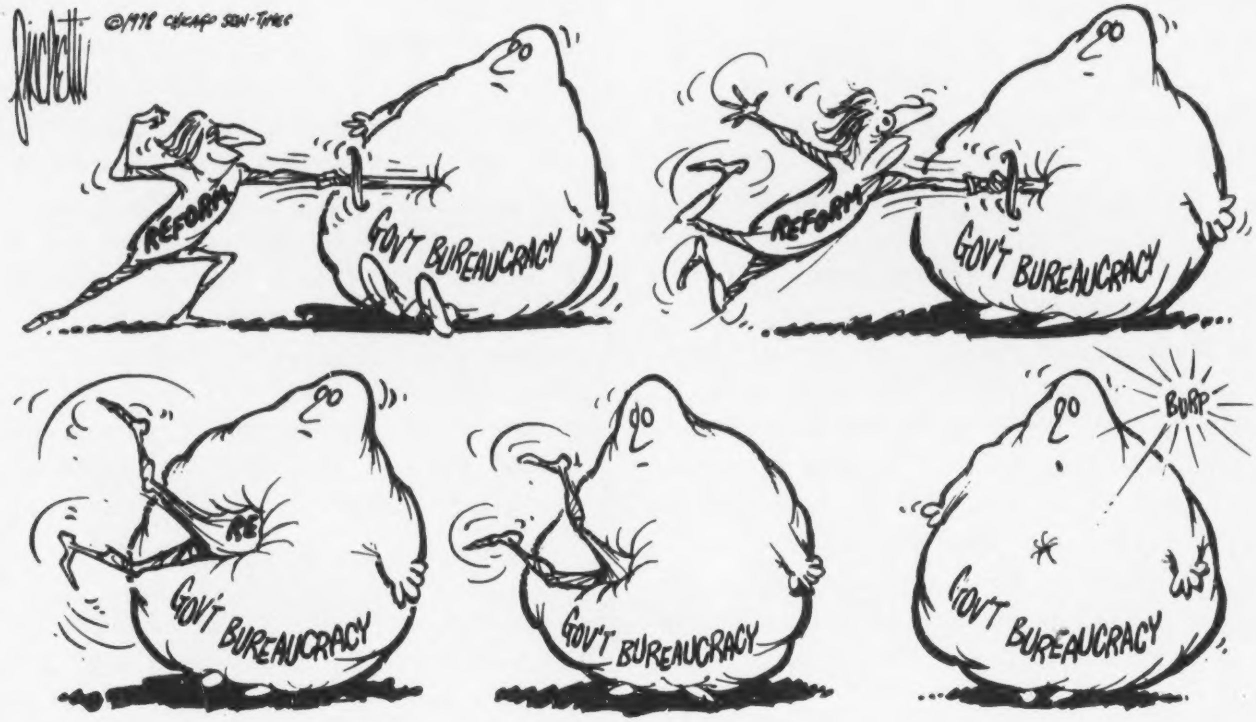
Railroads. Carriers have new pricing freedom under the Rail Act of 1980, which limited Interstate Commerce Commission jurisdiction to railroads that exercise "market dominance." The effect was to eliminate government control over roughly two-thirds of all railroad rates.

Railroads have increased their share of total freight traffic in the past two years. Gains have been substantial in some commodities (such as fruits and vegetables) that had previously been carried almost entirely by trucks. Rail profits, meanwhile, have held steady despite stagnation in the general economy.

Trucking. The Motor Carrier Act of 1980 relaxed control over entry into the industry and allowed more freedom to set prices. Published trucking rates are now widely discounted. Shippers are reported to be satisfied with the rates, services, and degree of competition for their business. It is true that the number of trucking-firm failures is up, due in part to the recent recession. But, at the same time, the number of new trucking firms also is up substantially. Opponents of deregulation had predicted that service to small communities would deteriorate. Generally, that has not happened.

Depository institutions. Of all sectors in the economy, financial services have been among those most heavily regulated. Partial deregulation of depository institutions is under way as a result both of laws passed in 1980 and in 1982 and of administrative decisions to accelerate the deregulatory process.

The introduction nationwide of NOW accounts in 1981, authorization of the new money market accounts at banks and at thrift institutions, and the phasing out of interest-rate restrictions have materially improved the ability of depository institutions to compete for funds with each other and with nondepository institutions. At the same time, thrift institutions have been granted greater leeway in investing funds–for example, by allowing them to make



By John Fischetti © 1978 Chicago Sun-Times; reprinted with permission.

consumer and business loans. Additionally, depository institutions are now able to offer variable-rate mortgages.

Despite progress in reducing regulation of financial institutions, consideration could be given to further action: for example, removing restrictions on banks that prevent branching across state lines. Advances in communication technologies, along with the greatly increased mobility of Americans, have widened geographical markets for financial institutions. Present regulations often hinder banks in interstate competition in natural market areas.

The Banking Act of 1933 (Glass-Steagall Act) should be amended to allow banks to underwrite municipal revenue bonds. Fifty years ago, revenue bonds accounted for a negligible portion of the municipal market; today they account for more than two-thirds of it. Studies by both private and government sources have shown that if banks were allowed to compete with securities firms in underwriting revenue bonds, greater competition would produce lower offering yields and reduced underwriting costs for state and local government issuers.

Telecommunications. Over the past two years, the Federal Communications Commission has revised a number of rules that were found to be unnecessarily restrictive and that imposed excessive paperwork requirements. Additionally, the FCC has undertaken a systematic review of its rules and policies–including the ranking of regulations according to priority.

Even so, much remains to be done. Some critics claim that the FCC concerns itself too much with the messages carried on the airways. Moreover, there is a feeling among some communications specialists that the FCC has not increased the number of broadcast outlets as quickly as it might have.

The job ahead

As these industry examples indicate, significant reform has been accomplished. And yet, the Administration is still far from its goal of clearing away the regulatory thicket.

At the moment, the Administration seems content to approach reform mainly by paring down regulatory budgets and staffs and by reviewing rules already on the books. There seems to be less willingness to push for statutory changes of the many laws that provide mandates to the regulatory agencies. As a result, many of the Administration's deregulatory efforts may yield transitory results.*

In Congress, there is some deregulation activity in the broadcasting and communications fields. But lawmakers are balking at efforts in other areas, such as the President's plan to accelerate the decontrol of natural gas prices.

More sweeping legislation has been put on the back burner. The proposed Regulatory Reform Act, for example, would give Congress veto power over nearly all new regulations issued by government agencies (certain regulations of the Defense Department and of the Internal Revenue Service would be exempt). Opponents of the bill argue that such veto power would violate the Constitution by usurping some of the powers of the Executive Branch (a view that the Supreme Court might ultimately have to rule on). Legislative observers say the reform bill's chances of passage this year are less than 50-50.

Restoring the earlier momentum for deregulation will require a new sense of urgency at the White House and in Congress. Priority emphasis on taxes and the budget is understandable. Sight should not be lost, however, of the continuing importance of reducing over-regulation. Outdated federal rules impair the economy's functioning, add to costs, blunt efficiency, and stunt productivity.

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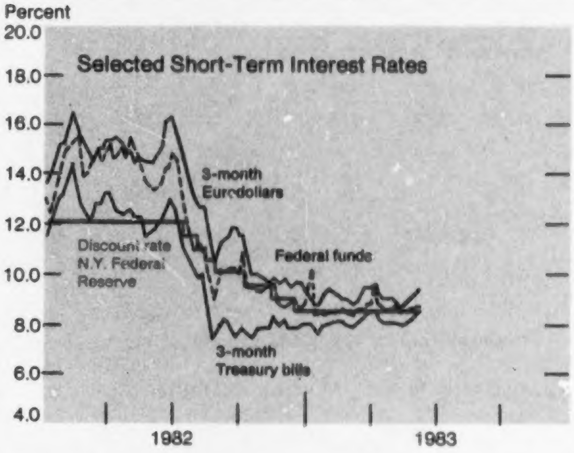
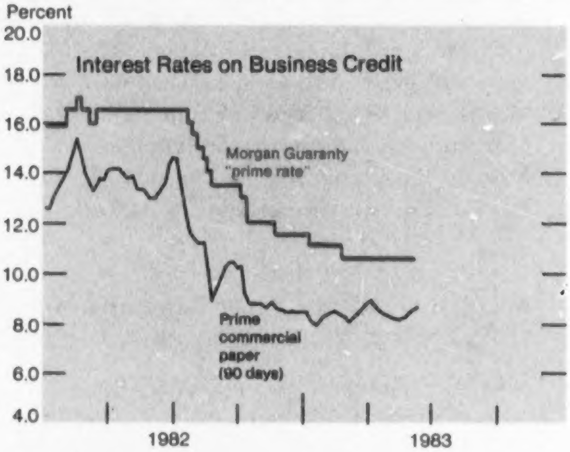
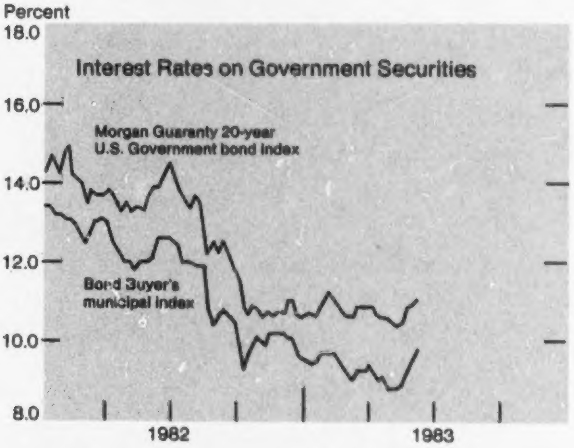
*As Catherine England put it recently in a report for The Heritage Foundation:

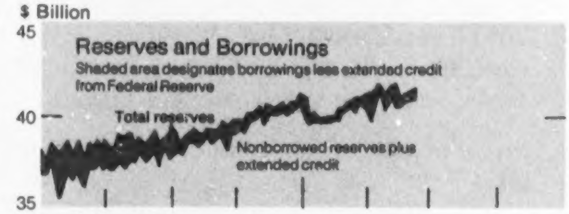
"The attitude of the Administration seems to be that with the 'right' people in power, statutory reform of the nation's regulatory system need not be pursued. If anything is certain in the political arena, however, it is that a new administration will eventually come to town, making new appointments, issuing new executive orders, and establishing new budget goals."

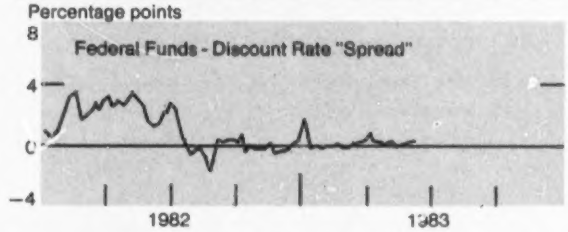
MONETARY INDICATORS

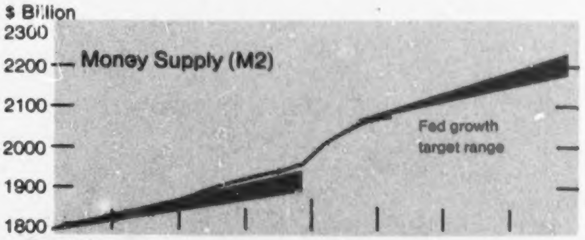


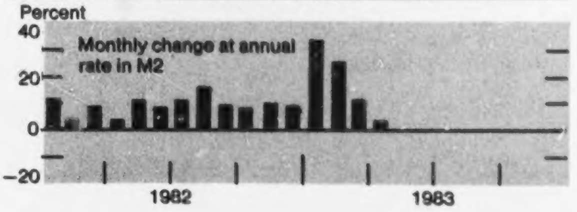


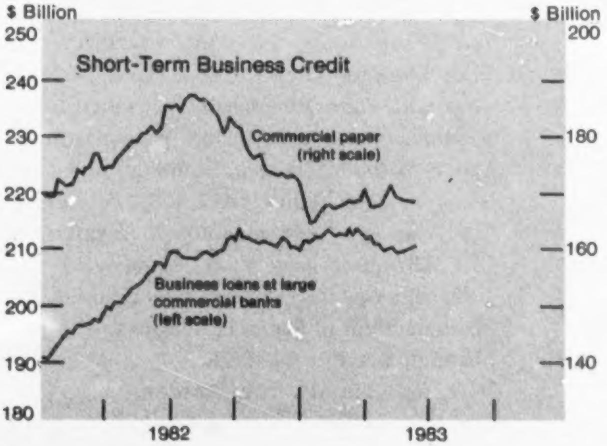












Note: M2 equals M1 plus overnight RPs and Eurodollars, general purpose and broker/dealer money market fund balances, money market deposit accounts, savings and small time deposits (net of IRA/Keogh balances). The 1983 M2 growth target is measured from an average February - March base. Business loans are net of bankers' acceptances. All data except interest rates and member bank borrowings are seasonally adjusted.

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JULY 1983

Economic Outlook. *Six months old, the recovery is showing plenty of vigor. Output and sales are up nearly across the board. Latest projections, quarter by quarter.* 1

Unemployment. *A return to "full employment" –a jobless rate of roughly 6% of the work force–is a key goal. What's needed to reach it and when it might arrive.* 5

Inflation Barometer. *Whither inflation? A new leading indicator has been developed that has a good track record. How the indicator works –and what it sees ahead.* 7

Federal Credit. *Uncle Sam's role as banker has ballooned. Credit programs reach $130 billion annually, a doubling in just five years. Needed: a better control mechanism.* 11

Economy Watch

THE recovery, now half a year old, keeps gathering momentum. The Morgan Bank expects real GNP to advance in the current quarter at an annual rate of 7½%, about two percentage points above the estimate made a month ago (table on page 4).

Larger-than-expected increases in auto production account for about half of the upward revision. Auto companies plan to raise production in the third quarter to an annual rate of 8.3 million units, more than 2 million above the rate in the second quarter. Scheduled production has been moved up progressively since plans for the third quarter were first announced in mid-April.

The rise reflects a major improvement in the public's car-buying mood. The sales rate for domestic makes, which had been flat at 6 million units from December to March, subsequently rose steadily to top 7 million last month. Higher scheduled production also reflects a new willingness on Detroit's part to build for inventory now that there is conviction about an improving sales pattern.

The other half of the upward revision in projected GNP growth comes from increases that have outpaced expectations in almost all other measures of output and sales.

In particular, the momentum in consumer spending–in nonauto as well as auto markets –has been impressive. A further decline in the personal saving rate from an already low level, in combination with solid gains in purchasing power, resulted in a large increase this past quarter in real consumer spending–5½% at an annual rate compared with only 2½% in the first quarter. An even faster spending pace seems likely during the summer, as the July 1 tax cut adds significantly to purchasing power.

Also contributing to brisk consumer spending is vigor in other sectors of the economy.

Housing, for example, continues to quicken. Builders apparently are encouraged by the sustained uptrend in sales of new homes. Sales have risen steadily from their low in the spring of last year, and are now running at an annual rate of about 650,000, about double the year-ago level. Turnover of existing houses (closely linked to the new-home market because most buyers must sell previously owned houses) also has surged—approaching an annual rate of 3 million as against less than 2 million a year ago.

Similarly, business investment continues to gain ground in a rise that is different from the customary pattern of lag at the early stage of cyclical recovery. Increasingly, investment has become concentrated in electrical and electronic products, such as computers and communications equipment. Growth in markets for such equipment made for an unusually large increase in spending on plant and equipment during the first half of the year. The changing composition of investment outlays presumably also lies behind continued growth in orders for nondefense capital goods. In the past few months, these have increased more rapidly than have shipments of such goods—up 15% between February and May as opposed to a rise of 5% for shipments. This is yet another sign that the uptrend in investment is solidly entrenched.

The most conspicuous exception to the pattern of improvement in the economy has been the deterioration in U.S. foreign trade, which was in deficit by a record $6.9 billion in May. Even that, though, is partly a reflection of the cyclical strength in this country's economy—strength that made for an especially large increase in imports of manufactured goods.

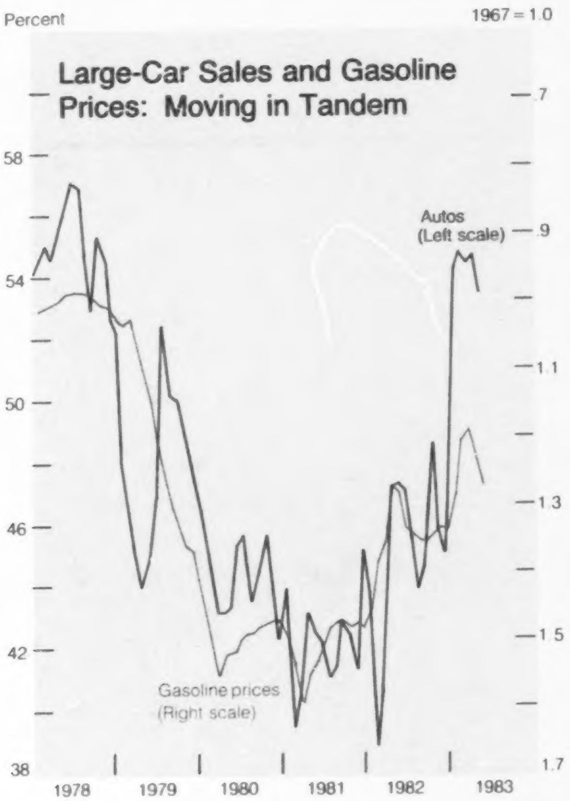
Developments later this year and into early 1984 will be conditioned by the mix of final demand and inventory investment in the next few months. At this juncture, however, unless final demand comes along at an unexpectedly fast pace—causing continued depletion of inventories of nonauto goods—the odds seem to favor a slowdown in the economy's growth. For one thing, auto output is likely to level off once the deliberate inventory buildup is completed. For another, the effects of the tax cut will be fading, to be replaced by the impact of rising payroll taxes. The growth in housing activity, moreover, seems likely to moderate, especially in light of the recent backing up in mortgage rates.

THE SWING BACK TO BIGGER CARS

SALES of the larger models are back in favor with car buyers. So far this year, intermediate- and standard-size vehicles have accounted for 54% of domestic cars sold, up from 45% in 1982 and higher than in any similar period since the oil-price shock of 1979.

In the wake of that shock, the market share of intermediate and standard-size cars fell as the price of gasoline rose sharply relative to prices in general (accompanying chart). As gasoline prices eased in 1981 and 1982, larger models began to grow in popularity. And, as the chart indicates, when gasoline prices tumbled early this year the big-car share spurted—beyond, even, what would have been indicated by the earlier close relationship to gasoline prices.

Car buyers may have overreacted, expecting even lower gasoline prices. Or they could have become suddenly more aware of improved big-car mileage ratings (an average of 23.0 miles per gallon now for a full-size Chevrolet compared with only 20.5 five years ago). This seems unlikely, however, because improved mileage has



Large-Car Sales and Gasoline Prices: Moving in Tandem

Note: Market share of standard- and intermediate-size autos. Gasoline price data, plotted on an inverted scale, show changes relative to the overall consumer price index.

been heavily stressed by auto makers ever since passage of the Energy Policy and Conservation Act of 1975, which set average fuel economy standards for the industry.

This same law may force a reduction in the currently large share of big-car sales. Up to now, Detroit's Big Three have easily met the fuel economy standards. They have even accumulated fuel-economy credits that can be used to offset future overages. GM and Ford now need those credits, because they have sold proportionally fewer compact and subcompact cars that deliver the highest milage. Despite such credits, however, both companies eventually may have to pay fines for not meeting overall mileage standards if the share of big cars stays at the current level. Such fines, by industry estimates, could run into the hundreds of million of dollars. Fines could be avoided, of course, if Congress should ease mileage standards. If not, the added costs may well be passed on to the consumer, raising big-car prices. That presumably would blunt demand and thus reduce today's comparatively high market share.

In the meantime, the market share of the bigger cars may well come down on its own—simply because it seems out of line with relative gasoline prices.

And foreign trade stands to remain a drag on over-all output. The effects of Washington's program to return government-held stocks of grain and cotton to farmers should also weigh heavily on farm output late in the year.

Whither interest rates?

A major question is how the Federal Reserve will respond to the robustness which the economy is showing and to faster-than-targeted growth in M1.

Thus far, the Fed—presumably constrained by the desire to avoid adding to the stress of international debtors—has been extremely cautious in curtailing the availability of reserves. The consequence is that the Federal funds rate has moved up only moderately from its trading range of a few months ago. Participants in securities markets, both debt and equity, clearly are concerned, however, that a more decisive move in the direction of restraint may occur.

Some indication of what the Fed intends should become evident very soon, since the July 12-13 Federal Open Market Committee (FOMC) meeting will surely involve a thorough exploration of alternatives in preparation for the Fed's mid-year report to Congress on policy targets. Those of "hawkish" inclination on the FOMC seemingly have the better part of the argument at the moment. They can invoke the economy's fast growth pace and the risk to Fed credibility if the growth in transactions money is not slowed. Additionally, they can argue that the progressive deregulation of deposit interest rates has almost certainly reduced the public's incentive to economize on money balances in response to higher rates. That implies the desirability of moving earlier rather than later to try to curb money growth. The Fed nevertheless may find it extremely difficult to embark on a really decisive restraining course because of the international debt situation.

There certainly is no easy choice. Cautious probing may be inescapable, with incremental increases in interest rates more likely than a sudden and substantial rise.

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1982		............*1983*............		
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−1.0	2.6	6.9	7.6	4.4
Real consumer spending	4.5	2.5	5.7	6.2	5.0
Real business-capital outlays	−6.0	3.8	2.5	3.2	3.8
GNP deflator	3.7	5.5	3.8	4.2	4.3
Consumer prices	2.0	−0.4	4.4	5.5	5.0
Real disposable personal income	0.3	2.2	3.6	11.7	4.3
Saving rate (%)	6.0	5.9	5.5	6.6	6.5
Housing starts (Millions)	1.3	1.7	1.7	1.8	1.7
Auto sales (Millions)	8.7	8.4	8.8	9.5	9.8
Unemployment rate (%)	10.7	10.4	10.2	9.9	9.7

Note: 1982 Q4 and 1983 Q1 data are actual.

Unemployment: How Fast Will it Shrink?

LABOR Secretary Donovan predicted in late May that the unemployment rate—hanging stubbornly at over 10%—would drop to 7½% in 1984. Martin Feldstein, the Administration's chief economist, is less sanguine. In late June he foresaw a jobless rate between 8.5% and 9% by the end of next year. The latter forecast is about in line with expectations of most business economists.

Everyone would like to see a return to "full employment"—a condition most analysts would consider reached when the unemployment rate stands in the vicinity of 6% of the work force. What's needed is a decline of about four percentage points in the jobless rate.

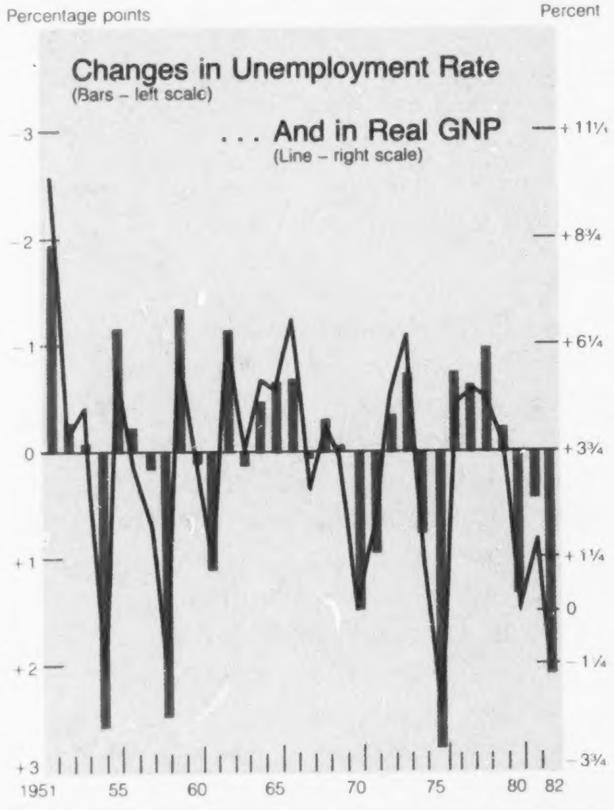
What would it take to reach that goal—and how rapidly might that come about?

Today's unemployed number roughly 11 million. To achieve full employment, that number would have to shrink to about 6¾ million. In short, more than 4 million new jobs need to be created—in addition, of course, to job creation to take care of normal growth in the labor force.

Obviously, such a major task cannot be accomplished quickly. In the Reagan Administration's long-term forecast, the unemployment rate does not get down to 6% until 1988. An analysis by The Morgan Bank concludes, similarly, that the full-employment goal probably will not be reached until near the end of the decade.

Restoration of reasonably full employment will require an enormous increase in overall demand for goods and services. Since 1951, on average, a 6¼% annual rate of increase in real GNP has been required to reduce the unemployment rate by 1% per year (chart on this page). That 6¼% is composed of a 3¾% trend rate of growth in potential real GNP (which had to be maintained merely to hold the unemployment rate constant in the face of a growing work force) and a 2½% cyclical increase in real GNP needed to lower the jobless rate by one percentage point (Okun's Law).*

If that relationship continues to hold, the generation of enough jobs to reduce the unemployment rate to 6% would require a 10% increase in real output (2½ times the needed four-point reduction in the jobless rate)—even



Note: Changes in the unemployment rate are the average unemployment rate in the current year minus the average unemployment rate in the previous year. Percent changes in real GNP are based on four-quarter averages of 1972-dollar GNP ending in the third quarter of the year.

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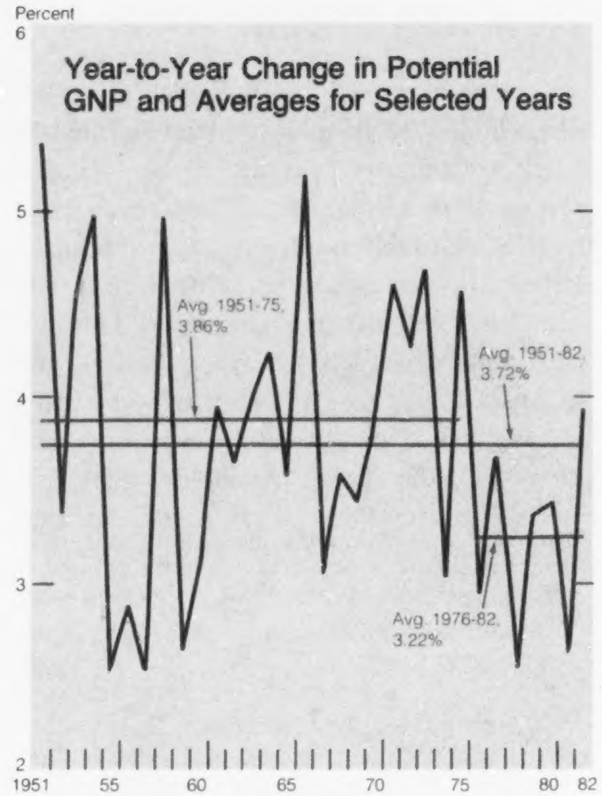
*In terms of structure, this is the famous "Okun's Law"—named after the late Arthur M. Okun, Chairman of the Council of Economic Advisers during the Johnson Administration.

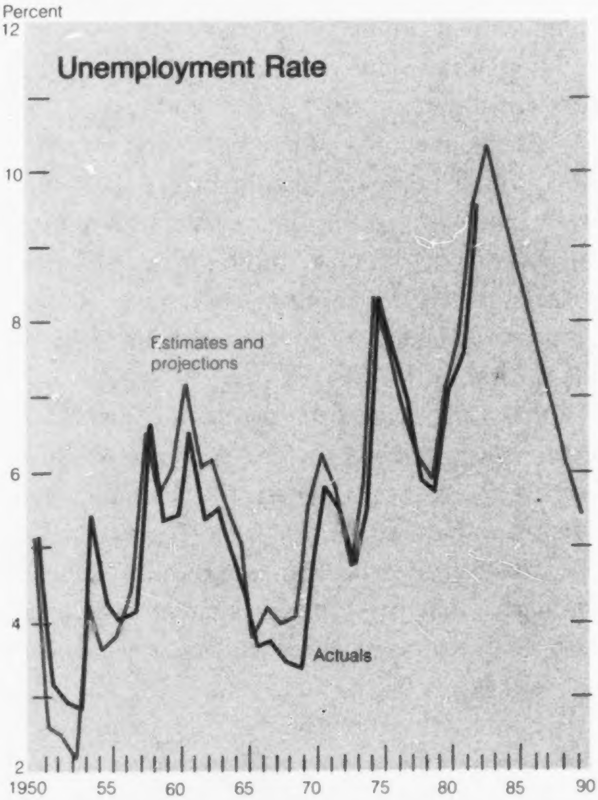

Year-to-Year Change in Potential GNP and Averages for Selected Years

Note: The year-to-year change in potential GNP relates to the four quarters ending in the third quarter of the calendar year. It is computed by multiplying the change in the unemployment rate by 2-1/2 and adding the percent change in 1972-dollar GNP (again for the four quarters ending in the third quarter of the calendar year.)

if the additional output could be achieved overnight. At current prices, that amounts to $330 billion—approximately $1,400 of additional goods and services for every man, woman, and child in the U.S. And to the extent that the additional output could not be achieved overnight, the increase would have to be large enough to provide also for normal labor force growth and the secular increase in output per worker. These two factors determine the growth rate of potential GNP.

The long-term trend of potential GNP has been obscured in recent years by the extended fall of actual GNP below its potential and by the persistent increase in unemployment. But estimates of year-to-year changes in potential GNP can be calculated using Okun's Law in reverse—that is, multiplying the change in the unemployment rate by 2½ and adding the percent change in real GNP. The result of that calculation for each of the past 32 years is shown in the chart on the left. The average of the annual changes in potential GNP was 3¾%.

Growth in potential GNP apparently has been slower than 3¾% since 1975, possibly as a result of the quantum jump in oil prices, though it isn't clear—in light of the acceleration of growth in 1982—that the slowing was more than temporary. There are, however, fundamental reasons for anticipating at least a mod-


Unemployment Rate

Note: Estimates and projections are formed by chaining from 1950 the estimated changes in the unemployment rate. These are computed by subtracting the percent change in real GNP from the estimated growth rate of potential GNP (3.86%, 1951-75; 3.22% thereafter) and dividing the remainder by 2-1/2. The percent changes in real GNP and potential GNP are for four-quarter averages ending in the third quarter of the calendar year. The projection is based on the assumption of a 5% rate of growth in real GNP through 1990.

erately lower rate of growth in potential GNP in the years ahead—most importantly, the decline in the growth rate of the working age population from 2.0% in the decade of the 1970s to 1.0% in the decade of the 1980s.* Yet, even with the assumption that the growth rate of potential GNP continues at the average rate of the 1976-82 period (3¼%), it is apparent that unemployment is going to remain a problem for the remainder of the decade.

Indeed, even with no faster growth in potential than that, and assuming that actual real GNP increases at a quite vigorous 5% annual rate, unemployment doesn't fall to 6% of the work force until near the end of the decade (chart on page 6).

Whether in the present economic environment a 5% rate of real growth can be maintained, on average, for the next six or seven years is an open question. Only in the mid-Twenties and the late Thirties and Forties did the economy keep up such a pace. Following the 1974 recession, a 5% rate of growth was maintained for only three years before accelerating inflation left no option to the Federal Reserve but to apply severe credit restraint. The legacy was sluggish performance for the economy from 1979 through 1982. The economic-policy challenge facing the Administration and the Federal Reserve is to find a set of policies that can prevent a reacceleration of inflation in an environment of sustained growth.

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*"Productivity: Signs of Improvement," *The Morgan Guaranty Survey*, September 1982.

Also: "The 1980s Reconsidered," *The Morgan Guaranty Survey*, April 1983.

A New Inflation Barometer

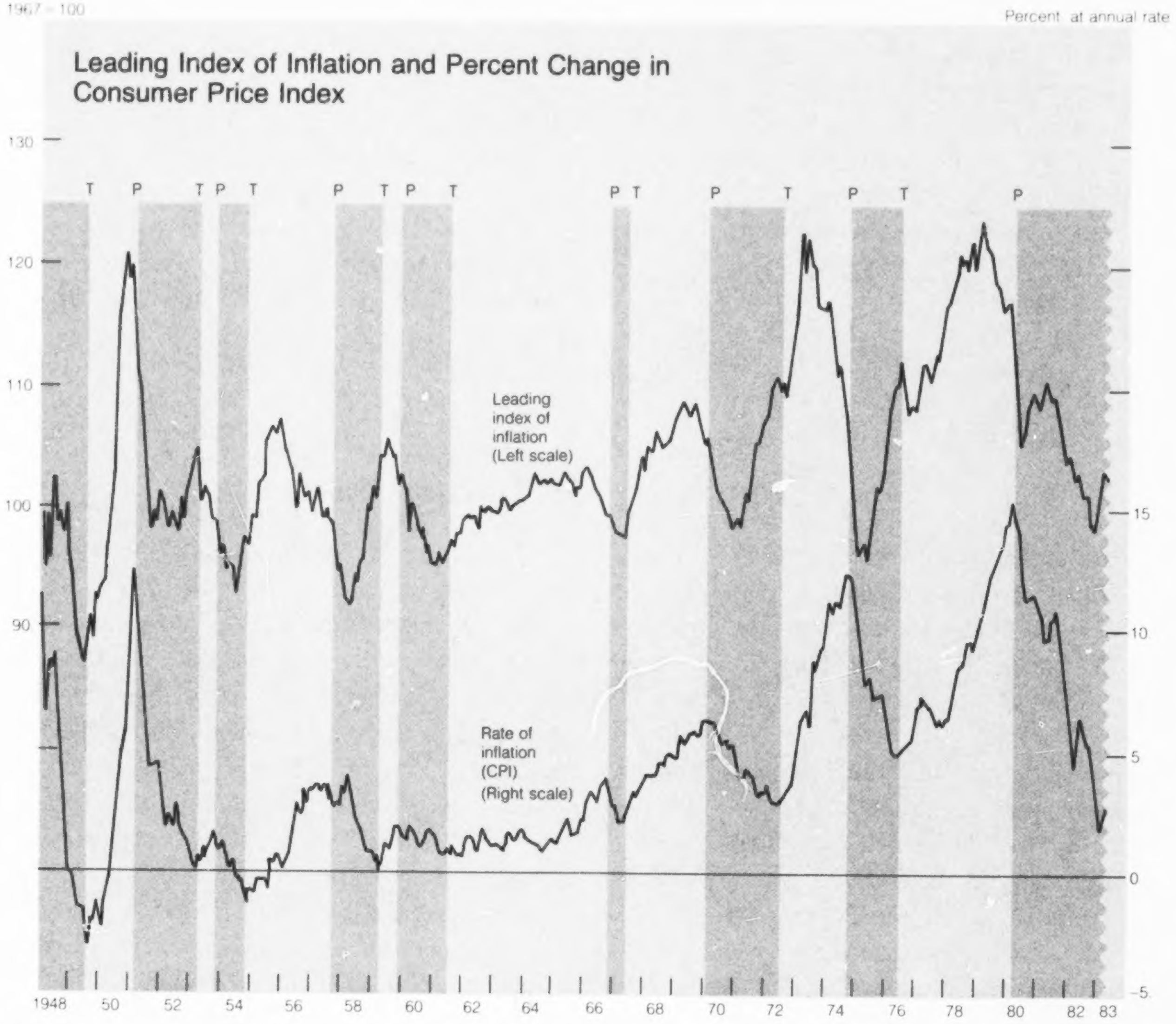
The following article was written by Geoffrey H. Moore, Director, Center for International Business Cycle Research, Columbia University, and by Professor Stanley Kaish of Rutgers University.

THE anxiety demonstrated by financial markets over the future course of inflation points up the difficulties forecasters have at turning points in the business cycle. The biggest forecasting problems are encountered around peaks and troughs. Studies have demonstrated that forecasting errors made by economists at turning points in real GNP are likely to be two and a half to three times as large as those made during sustained economic expansions and contractions.

Leading economic indicators are especially selected with a view to their capacity to anticipate cyclical turning points. The extra eagerness with which analysts have awaited the Commerce Department's index of leading economic indicators in recent months is itself an indicator of their usefulness at this particular time. The Center for International Business Cycle Research has recently developed a specialized leading indicator which, while still experimental, shows promise of helping analysts forecast speedups and slowdowns in the inflation rate. That is, it should help catch the turn in inflation.

The index reflects the intensity of demand pressures in the labor market, in the commodities markets, and in the capital markets. It is a composite of three monthly series: the percentage of the working age population that is employed, the annual rate of change in prices of industrial materials, and the annual rate of change in total business, consumer, and federal debt outstanding. As the chart on this page shows, the index has reached its turning point before every one of the 16 cyclical turns (eight peaks and eight troughs) in inflation from 1948 to the present.

To be considered a leading indicator, an economic time series must have more going for it than simple statistical correlation. There must also be sound economic reasons why it turns early. Briefly, the reasoning underlying the three selected series is as follows:


Leading Index of Inflation and Percent Change in Consumer Price Index

Note: Shaded areas represent cyclical declines in the rate of inflation (CPI). Percent changes are annual rates based on ratio of current figure to its average over the preceding 12 months.

1. The percentage employed foreshadows inflation through its implications for both the supply and the demand sides of the market. When a greater share of the population is working, upward pressure is placed on wages, costs, and hence prices. An employer seeking workers is more likely to have to bid employees away from other jobs. At the same time, the higher personal income earned by the larger proportion employed—including many two-earner families—means greater purchasing power in the hands of consumers.

2. Prices of industrial materials such as scrap metal and cotton textiles react promptly to supply and demand pressures. They are less affected by labor costs than the finished goods and services represented in the consumer price index. Since unit labor costs are slow to change, their lesser role in industrial materials prices makes those prices more sensitive to changing market conditions. Moreover, market conditions at this level more closely approximate the purely competitive model with its assumptions of standardized products and auction markets among many buyers and sellers. Prices are less likely to resist market forces under these conditions than in the finished goods and services markets.

3. Finally, the highs and lows in the rate of change of total debt outstanding anticipate highs and lows in inflation because new borrowing is generally undertaken to finance the purchase of goods and services. When debt accumulation increases, greater demand generally follows; when debt accumulation slows, demand and inflation ease.

Cyclical Turning Points in Inflation Rate (CPI) and Lead or Lag of Four Indicators

Inflation turning points	*Composite leading index*	*Percent employed*	*Growth rate, debt*	*Growth rate, materials prices*
Months Lead (−) or Lag (+) at Inflation Peaks				
2/51	**−3**	*	n.a.	−3
10/53	**−7**	−7	n.a.	*
8/57	**−20**	−12	−23	−20
10/59	**−3**	+8	−2	−11
10/66	**−9**	*	−40	−23
2/70	**−10**	−2	−10	−5
9/74	**−18**	−6	−18	−7
3/80	**−12**	−3	−21	−12
Average	**−10**	−4	−19	−12
Months Lead (−) or Lag (+) at Inflation Troughs				
7/49	**−1**	+3	n.a.	−1
3/53	**−7**	*	n.a.	−12
10/54	**−3**	−3	−3	*
3/59	**−11**	−8	−13	−16
6/61	**−4**	+20	−2	+13
5/67	**−1**	*	+1	−7
6/72	**−19**	−15	−26	−15
6/76	**−12**	−12	−12	−17
Average	**−7**	−2	−9	−8

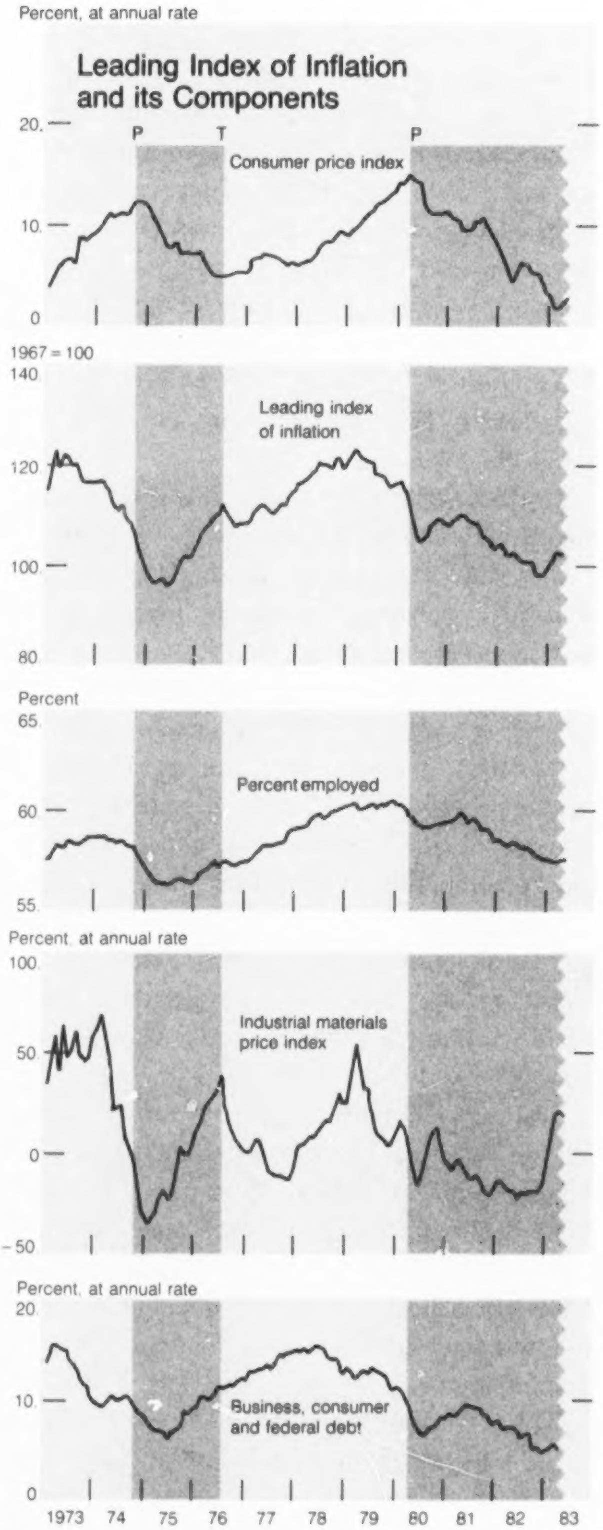
n.a.: Not available. Series begins in 1954.
* No turn in indicator.

The accompanying table shows the number of months by which turning points in the leading index as well as in its components have led or lagged behind the peaks and troughs in inflation. It is apparent that none of the series by itself is as reliable an indicator as the composite index that combines them all. Each of the individual series falters at one point or another in the chronology, missing some turns, lagging at others, and occasionally turning independently of inflation. The composite, however, anticipated all turns, giving a warning, on average, of ten months at the peaks and seven months at the troughs.

The accompanying chart compares the behavior of the index and its components with that of the inflation rate since 1973. Inflation declined after the severe recession of 1974-75 was well under way and bottomed out at just under 5% in June 1976. At the time we could not know that the June figure would be the low. But if the leading index of inflation had existed, it would have been going straight up for a full year before June 1976, signaling an upturn.

At the beginning of 1980, many believed inflation was here to stay. March, however, turned out to be the peak month. Again the leading index would have anticipated the easing of inflation by a full year, with substantial declines in the growth of debt and in commodity price pressures. The index turned down after reaching 123.8 (1967=100) in March 1979 and fell rather steadily until June 1980. Over the next six months the index would have given one of its few false signals, reflecting the business cycle recovery that began in July 1980 but was aborted a year later. Inflation briefly ticked back into double digits in 1981, but weakness in the economy prevented any sustained rise.

The index's most recent low was in December 1982 (98.4), coincident with the recession trough. It has risen in four of the last five months, reaching 103.3 in May. All three of the components have contributed to the rise in recent months. However, the main thrust has come from the sharp rise in materials prices, with only minor gains in the growth of debt and in the percentage employed. Thus, while the weakness in the economy that produced disinflation over the past three years has subsided, the excessive pressures that typically cause consumer prices to rise with business expansion have not yet appeared.



Note: Shaded areas represent cyclical declines in the rate of inflation (CPI). All percent changes are annual rates based on ratio of current figure to its average over the preceding 12 months.

Improving the Credit Budget

THE yearly volume of credit extended or guaranteed by the federal government and its sponsored agencies has quintupled during the past decade. The total in fiscal 1983 is expected to exceed $130 billion, up from $26 billion in 1973. Federal credit growth has been particularly rapid since the mid-Seventies, outpacing the growth of total credit. As a result, credit programs have accounted for over 20% of credit extensions in recent years, compared with 10% to 15% annually during the early Seventies.

The surge has heightened concern that credit programs are being used excessively—mainly because most of them are "off-budget" and thus their costs are less visible than those of budgeted outlays. That concern, in turn, has spurred little-noted but important efforts by Congress to curb the growth of credit activities. Success in those efforts could have major implications for private borrowers, because credit programs, like the budget deficit, have to be financed in markets where private and public claimants compete for the same limited resources.

Prodded by the Carter and the Reagan Admininistrations, Congress has begun to set targets for direct-loan obligations and guarantee commitments for the first time—stipulating such credit-budget totals in Congressional budget resolutions.* Also a first, the legislators have subjected new activity in most loan and loan-guarantee programs to the appropriations process. Credit assistance not subject to that process—such as loans to veterans which are in the nature of entitlements—nevertheless is subject to limits because it is included in the credit-budget totals.

The control mechanism has had far from stringent effects thus far, since Congress has tended to authorize obligations and commitments that have exceeded prevailing loan and loan-guarantee volumes. Even so, adoption of the mechanism is a major step in the right direction. Among other things, it has helped create a receptive climate for the Reagan Administration's efforts to trim some highly subsidized programs—such as those providing loans to students, small businesses, and home buyers. Congress, however, still has a long way to go before it transforms the credit budget into an effective instrument for making decisions about how, and to what extent, Washington should use credit programs to direct national resources to desired ends.

Further steps in that transformation appear to be in the offing—particularly in view of the Reagan Administration's challenge to Congress to pare credit programs dramatically.

As the chart on page 12 shows, outstandings of federal and federally assisted credit will amount to about $900 billion at the end of fiscal 1983—including in the count credit advanced by government-sponsored enterprises as well as the direct-loan and loan-guarantee programs that have been put under the credit budget. The 1983 total would be two and a half times the total outstanding at the end of 1976. The rise reflects rapid expansion in credit programs of all types:

Direct-loan programs. Many of these are highly subsidized and received impetus in the 1970s from the operations of the off-budget Federal Financing Bank (FFB). Part of the

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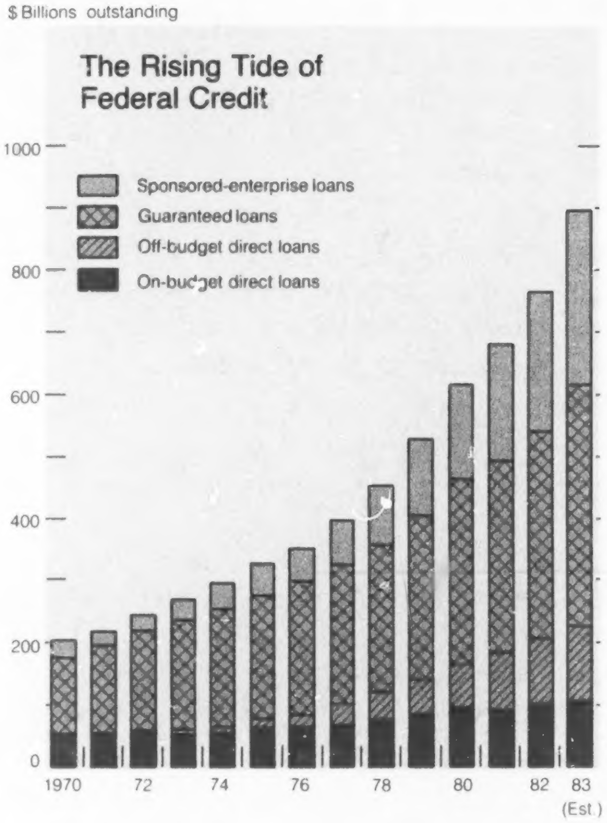
*Obligations and commitments were chosen as the policy variables because they are most amenable to control. Net credit extensions depend on these variables, and on repayments of old loans over which the government has no power.

Treasury Department, FFB was set up by law in 1973 to coordinate the borrowings of federal agencies that previously had tapped credit markets on their own at higher costs than the Treasury paid to borrow. The idea was to have the Treasury do the borrowing for the agencies in order to reduce their costs.

FFB's role, however, soon expanded way beyond that of low-cost middle-man. Several on-budget agencies–particularly the Farmers Home Administration–have used FFB as a vehicle for expanding loans that otherwise would have been counted as budget outlays. Such agencies simply sell the loans they make to their constituents to the off-budget FFB, thereby putting such loans off-budget. In accounting terms, because of special provisions of law, the sales of agency loans are subtractions from agency outlays. In economic terms, the activity promoted by the original loans is unaffected, as is the federal government's role as financier. Since the FFB has had no authority to curb agency activity, and since Congressional overseers could always argue that the expansion of loan programs was "costless"–or at least invisible–to the taxpayer, the inevitable result has been a rapid rise in direct loans channeled through FFB.

What is more, federal agencies have used FFB to provide federal funds directly to their constituents in lieu of guarantees. The FFB has met its statutory obligation to purchase agency-guaranteed loans by extending credit directly to guaranteed borrowers–in effect, converting guarantee programs into direct-loan programs. Beneficiaries, such as rural electric cooperatives and foreign buyers of U.S. military hardware, need not go through the intermediate step of lining up private financing. This development has greatly increased the value of the aid that Washington extends to such borrowers and to the varied activities in which they invest.



Note: Guaranteed loans are adjusted for those guaranteed by more than one agency and for those held as direct loans by the federal government. Sponsored-enterprise loans are adjusted for loans between sponsored enterprises, for direct loans to sponsored enterprises by government agencies, and for sponsored-enterprise loans that are guaranteed by the federal government.

Ordinary guarantee programs. These also have expanded rapidly in recent years, as more and more borrowers have secured funds on favorable terms because of Washington's assurance of loan repayment. The growth reflects extension of guarantees into such new fields as lending to students, exporters, and small businesses as well as expansion of the traditional mortgage-credit underwriting activities of the Federal Housing Administration (FHA) and the Veterans Administration (VA). In addition, Washington has used guarantees in recent years to provide aid to particular borrowers, such as New York City, the Chrysler Corporation, and producers of synthetic and other exotic fuels.

Federally sponsored financial intermediaries. Sponsored agencies were designed by law to promote selected kinds of economic activity, mainly housing and agriculture. Their outstandings have doubled in the past several years, mainly because of the relatively recent secondary mortgage-market activities of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. These agencies have broadened the sources of home-mortgage credit—attracting new investors into the mortgage market by packaging and selling home loans in the form of standardized securities.

While the sponsored agencies are privately owned, they have unique ties to Washington—including, for example, authority to borrow from the Treasury and exemption of their offerings in securities markets from registration with the Securities and Exchange Commission. Such links, and the federal government backing they imply, enable the sponsored agencies—and ultimately the constituents they serve—to borrow at rates only slightly above Treasury rates.

Next steps

As Congress refines its new credit-budget procedures in coming years, it must confront more actively than it has to date the question of the appropriate level of federal credit assistance. Many legislators, especially those on the budget committees, are pressing to make the obligations and commitments totals binding. Thus far, judging by the comparatively high levels that Congress has set in budget resolutions, the credit-budget totals have been more forecasts than targets. Also, Congress often has failed to meet its own requirement to legislate appropriations limits for individual loan and loan-guarantee programs, or it has set appropriations limits so high as to have little significance.

Advocates of a more effective credit budget also are attempting to control entitlements, such as veterans loans, and to devise a better system for monitoring such things as FHA and export-credit guarantees which fluctuate with economic activity. Neither kind of credit program is easily governed through appropriations. In such cases, the control mechanism presumably must rest on such basic program features as eligibility.

In addition to the appropriate level of federal credit activity, several other issues should be addressed in any reform of the credit-budget process. For one thing, distinction needs to be made between credit programs that have a powerful conditioning influence on how resources are used and those that have only a negligible impact. The economic effects of direct loans for housing rehabilitation at 3% interest rates, for example, are vastly different from the effects of guarantees by the FHA of mortgage loans at or close to market rates. In the first case, the investment the program aims to promote probably would not take place without the subsidy; in the second, the investment—especially now that private mortgage guarantees are commonplace—presumably would go forward without federal involvement. The summing-up procedures of today's credit budget make no such distinction.

A related issue is how the credit budget should be integrated with the expenditure budget. Preferably that would be done in a way that recognizes explicitly that credit programs, although widely different in impact, are nevertheless close substitutes for expenditure programs.

One approach along these lines, suggested by officials of the Congressional Budget Office, would be to replace today's independent spending and credit budgets with an accounting framework that encourages trade-offs between the two.* If the objective were, say, to reduce government support of agriculture by $1 billion (or, for that matter, raise its support by the same amount), Congressional committees would be given the option to meet that goal in whole or in part by reducing (or increasing) the related loan and loan-guarantee activity.

The trade-off approach reflects the view that credit programs are troublesome because they never have been subjected to competition with spending programs for real and financial resources. Congress as a result has not had adequate incentive to govern credit-program growth. The idea of trade-off advocates is not necessarily to limit the intrusion of credit programs into financial markets. In many cases, such intrusion is warranted—indeed, welcome—if national purposes are to be met. Rather, the idea is to force Congress not only to recognize credit-program costs explicitly, but also to take them fully into account as it designs expenditure programs whose objectives, after all, are the same as those of the associated credit activities.

Integrating the credit and spending budgets would present accounting problems, but not insuperable ones. A dollar of new-loan obligations or guarantee commitments cannot be considered the programmatic (and economic) equivalent of a dollar of purchases or transfer payments by Washington. And, as noted earlier, the economic effects of credit programs vary widely. Indeed, the closer a credit program comes to promoting economic activity that would have occurred anyway—the sale of a house with an FHA or VA guarantee, for example—the less comparability there is between spending and lending.

Still, establishing a factual basis for making trade-offs is possible. For direct loans, the discounted present value of the subsidy given to a borrower could be used as the measure of the relative cost of loan and expenditure programs. High present values would indicate that a dollar lent by the federal government approaches the economic equivalent of a dollar spent. For guarantees, estimates of the difference between the interest paid by a borrower with government backing and by one without it might be the measure. Alternatively, expected defaults could be treated as a guarantee program's costs for budgetary purposes.*

Some notion of the trade-off between expenditures and direct loans is contained in estimates made by the Office of Management and Budget and presented in an appendix to the President's budget message. Last fiscal year, for example, the discounted present value of the subsidies of new direct loans came to an estimated $12 billion—almost 20% of that year's obligations. In some programs, whose interest rates were set many years ago and never revised to reflect the secular rise in interest rates of the past 20 years, the present value of subsidies was estimated to be more than 50% of

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*Alice M. Rivlin and Robert W. Hartman, "Control of Federal Credit Under the Congressional Budget Process," *Toward a Reconstruction of Federal Budgeting: A Public Policy Research Program*, The Conference Board, 1983.

*The President's Commission on Budget Concepts, in its 1967 report, advocated disclosure of subsidies, and loss reserves for guaranteed loans, in the expenditure account of the budget—one of the few recommendations the Commission made that was not ultimately adopted. "The importance of spelling out the amount of loan interest subsidy," the Commission concluded, "is not so much in revealing the dollar effect within the budget as in providing a better measuring stick to the government policy makers to help them decide on the relative merits of allocating resources among competing direct loan programs or between loans on the one hand and grants-in-aid or direct expenditures on the other."

obligations. Figures of that magnitude–which have resulted from Washington's failure to adjust the interest rates accorded favored borrowers–underscore the substitutability of direct-loan and expenditure programs.

The implicit cost of guarantees is not so easy to estimate. If expected defaults are used as the basis for calculating costs, problems would arise. A single-purpose loan–to, for example, a synthetic-fuels producer–has no default experience to draw on. Moreover, data on the default experience of some agencies are far from reliable. Still, for the major programs–home mortgages, student loans, and export credit–reasonably complete default records exist. If comparisons between costs incurred by borrowers with government backing and by those without it are used as the basis for measurement, single-purpose borrowers again would present problems. They typically cannot secure credit at any cost in the absence of federal help. However, for the most part, estimates of differences between guaranteed and nonguaranteed borrowing costs can readily be calculated.

The Administration's challenge

Congress cannot avoid responding to the challenge of devising a fully effective control mechanism for credit programs. That was posed forcefully by the Administration's proposal to hold new direct and guaranteed lending below 1983 levels for the next five years. Specifically, the proposal was to hold such lending a cumulative $145 billion (some 18%) below what the Congressional Budget Office has estimated it would be if today's programs, adjusted for anticipated inflation, were simply maintained. How Congress responds to the Administration's credit-curtailment proposals will have a lot to do with the degree of difficulty encountered in financing the inevitably large on-budget deficits of the next few years.

In view of those deficits, Congress has a special reason to give close attention to credit programs. They all may have had useful purposes when they were established, but their suitability in today's conditions needs critical review. Recognition of that presumably lies behind draft legislation to revise the FFB act and bring the activities it finances on-budget once again where they will have to compete directly and openly with expenditures.

Helpful as such legislation would be, the need is for reexamination of credit programs on a broad scale. It is appropriate, for example, to ask if the need still exists for the federal government to underwrite mortgages side by side with private insurers. Indeed, a whole range of loan and loan-guarantee programs providing relatively shallow support should be looked at anew to see if federal involvement really is needed in present circumstances. Similarly, hard questions should be raised about the need for the sponsored credit agencies to have favored status as financial intermediaries. The packaging of home mortgages, after all, is hardly a new business that needs government to pave the way.

Perhaps the most constructive single step Congress or the Administration could take, to give a focus for decisions about credit programs, would be to convene a commission on budget concepts. The 1967 commission laid the groundwork for a system of accounting for federal activities that all too often has been honored in the breach. Such a commission might be especially useful if its charter were written broadly enough to allow it to address the substantive issue of what credit activities are appropriate in today's conditions as well as the procedural issue of how such activities should be treated in the budget accounts.

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Budget Escapism:
An Increasingly Risky Course

A not-so-subtle change in political thinking about budget deficits has occurred during the past six months. What used to be a deep sense of concern about doing something to blunt the damaging economic effects of mammoth deficits has given way to a mood of resignation. This change results partly from the fruitless effort in Washington during the late winter and spring to fashion a deficit-reducing plan that could command a Congressional majority.* But it also reflects a hope that the unexpected strength of the economic recovery will somehow cause a rapid melting away of the large deficits, thus eliminating the need for unpleasant expenditure cuts and/or tax increases.

Self-deception may work for a time in Washington. It will not work—and is not working—in the nation's financial markets. The past two months have seen a disturbingly large rise—well over a percentage point—in the yields on long-term government securities. Many financial-market participants clearly are reluctant to acquire debt instruments because they fear that the fiscal deadlock will eventually force the Federal Reserve to choose between two policy alternatives. The first would be to monetize a large portion of the debt, thereby enlarging the money supply and adding to inflationary pressures. The second would be for the Fed to resist accommodating the deficit and let the combined demand for credit—both public and private—

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*Congress did adopt a fiscal-1984 budget resolution in late June, but there was little expectation that it would be acted on. Indeed, the tax and appropriations committees failed to come up with implementing proposals by July 22 as required by the resolution, and the deadline was extended to September. Few in Washington, however, seem to have confidence that a deficit-reducing program will be passed by the new date.

bring about a rise in interest rates. Either way, holders of debt securities would lose.

The Administration's unveiling on July 25 of revised budget estimates for fiscal 1984 (incorporating the positive effects on government receipts and outlays of the improved economic outlook) has done nothing to quell investor anxieties. Cyclical improvement in federal finances is important and welcome, because every dollar of deficit reduction means one less dollar of federal borrowing to compete with private-sector financial needs and one less dollar of debt that will have to be serviced by future taxpayers. The trouble is that the greater-than-anticipated cyclical improvement in federal finances is of only marginal importance compared with the underlying structural budget problem.

The Administration's own revised midyear budget estimates (summarized in the accompanying table) make that abundantly clear. Particular attention should be focused on the so-called baseline, or current-services, projections that are shown in the second line of the table. These projections estimate the size of future budget deficits that will emerge if all existing expenditure and tax programs simply are continued for the next five years. The baseline estimates are particularly relevant at this time, given the inability of Washington's political leadership to agree on major spending and tax initiatives. The more frequently quoted projections of what the Administration expects future deficits to be if its recommendations for policy change are followed (shown in the first line of the table) are of less interest at the moment. This is because they embody many controversial spending and tax proposals that seem to have little chance of being approved by a stalemated Congress.

Unhappily, what the midyear baseline projections reemphasize is that, even with a faster-than-previously-estimated reduction in the cyclical portion of the deficit,* the total deficit will

Midyear Deficit Reestimates

(Fiscal years; billions of dollars)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*
Administration's proposed deficit*	209.8	179.7	170.2	129.0	118.4	82.3
Baseline deficit*	209.8	200.4	205.9	219.0	228.4	209.8
Less: Effects of high unemployment**	110.0	88.2	72.5	53.9	36.0	11.6
Structural deficit	99.8	112.2	133.4	165.1	192.4	198.2
Memo: Deficit as a percent of GNP						
Baseline	6.5	5.6	5.3	5.2	5.0	4.2
Cyclical deficit	3.4	2.5	1.9	1.3	0.8	0.2
Structural deficit (excluding Congressional action)	3.1	3.1	3.4	3.9	4.2	4.0

**Mid-Session Review of the 1984 Budget*, July 25, 1983.
**Morgan estimates.

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*The fact that the Administration made more bullish economic projections at midyear than last January resulted in a $24-billion reduction in its estimate of the fiscal-1984 deficit.

remain alarmingly high for an indefinite period because of a built-in tendency for the noncyclical, or structural, component to rise over time. Indeed, the structural portion of the deficit* climbs from 1% of GNP in fiscal year 1979 to an unprecedented 4% in fiscal 1987. This deterioration is caused mainly by the unwillingness of political leaders to slow the growth in nondefense spending enough to compensate for the combination of the buildup in the nation's defense capabilities and the tax cuts enacted in 1981. What has been particularly disappointing has been Washington's incapacity to come to grips with the sharp upward momentum in spending under the major entitlement programs.

The dangers ahead

Unless checked, the Treasury's red ink will add over $1 trillion to the public debt during the fiscal 1984-1988 period—a near doubling in just five years. If such a rise occurs and market interest rates remain at approximately present levels, the Treasury by fiscal 1988 will find itself facing about $220 billion of interest payments annually to service over $2 trillion of outstanding public debt. Such an interest burden would be roughly equivalent to current spending for national defense. Both the ratio of federal debt to GNP and the ratio of interest payments to GNP, each of which has recently reversed the downward trend established after World War II, would follow a path of steep ascent (charts on page 4).

The likely consequences of these increases are unsettling:

The Socialization of Savings. The federal government would absorb 53% of total net private savings (after allowance for depreciation) over the next five years. The ratio averaged only 20% in the 1970s. Such a socialization of savings would be unheard of in this country during peacetime. It is particularly ironic that this should be the outlook at a time when a conservative Administration remains committed to reducing the role of government in the U.S. economy. One of the more worrisome features of such a massive absorption of net savings by government is the adverse implications it carries for private-sector capital formation. This is because the scramble for the savings left over after the Treasury has satisfied its huge needs for funds will tend to push interest rates upward. High rates of interest can be a formidable hurdle, of course, to investment undertakings.

If the heavy financing needs of the federal government, in fact, prove an obstacle to private-capital formation, the ultimate consequences will be poorer productivity performance, decreased overall growth, slower gains in real income, and reduced U.S. competitiveness abroad. And there is certainly every reason to believe that the sorely needed upgrading of the nation's social infrastructure (roads, bridges, and water supply systems) will not go forward very vigorously unless means are found to curb the federal government's voracious appetite for funds to finance existing programs.

A Worsening Trade Outlook. Another effect of the large deficits and accompanying high interest rates is that the exchange value of the dollar very likely would continue to be nudged upward in international currency markets. Already, the strong dollar has appreciably reduced the competitiveness of U.S. exports in world markets and has made it easier for foreign producers to sell in this country. Weakness in net exports accounted for an exceptionally large share of the decline in real GNP during the 1981-82 recession (about two-fifths of the decline from peak to trough). And the dampening effect of the strong dollar on the economy is far from over. The U.S. trade deficit, which ran at a record annual rate of $46 billion in the first half of 1983, could easily reach an annual rate of $70 billion by yearend. With U.S. production below what it would be with a more competitive dollar, employment and income are being significantly depressed, and many export-producing and import-competing industries are being seriously damaged.

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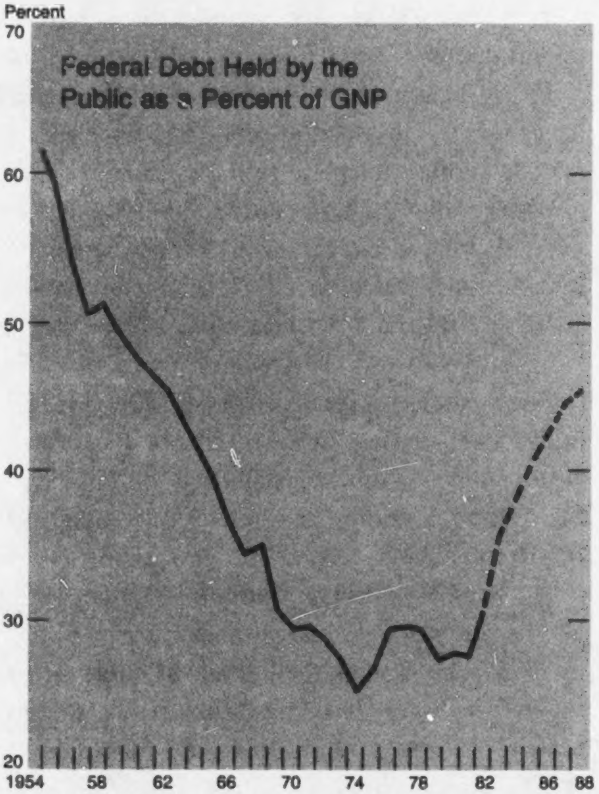
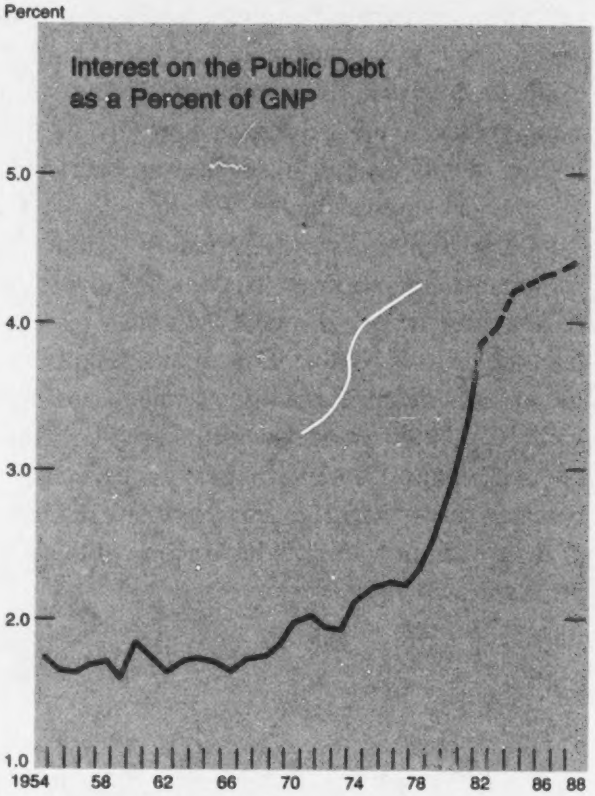
*This is the deficit that would exist if the economy were operating at its high-employment potential, commonly defined these days by economists as the output the economy would produce at an unemployment rate of about 6%.



Note: Projections for public debt are based on the Administration's July estimates of the baseline or current-services budget deficits. Plottings are for fiscal years.



Note: Projections of interest payments are based on the Administration's estimates of the baseline or current-services budget deficits and the corresponding borrowing needs. Plottings are for fiscal years.

Protectionism. The strong dollar, because of its depressing effect on U.S. jobs, also is generating a rising tide of protectionist sentiment in this country. To the extent that the Administration and Congress are responsive to this sentiment (and the risk of competitive political responsiveness is clearly heightened by the approach of the 1984 election), the threat exists of a vicious cycle of trade restrictions and counter restrictions worldwide. The European Common Market already has threatened action in response to the Administration's recent restrictions on U.S. imports of specialty steels. If protectionist sentiment grows, the consequences will be a gradual decline in world trade. And as always, consumers–both in the U.S. and elsewhere–will be victimized as they are confronted with higher prices for goods.

Borrowing from Abroad. During the past year, high U.S. interest rates and the strong dollar have encouraged sizable foreign investment in the U.S. In the most recent three quarters for which data are available, such investment (probably understated in official statistics) took the form of $19 billion of Treasury debt, $4 billion of corporate bonds, and $5 billion of corporate equities. From a parochial point of view, these foreign investment funds are welcome as a supplement to U.S. domestic savings: They cushion the adverse effects of the Treasury's extraordinary drain on savings. In a broader context, however, the appropriateness of a siphoning-off of a disproportionate share of the world's limited savings by an advanced industrial economy is questionable.

Growing dependence on foreign savings inflows has other troublesome aspects as well—in particular the complications that will arise when and if foreigners become less inclined to place funds here. That contingency may seem remote now because of the attractive yields available on U.S. debt instruments. But conditions favoring foreign investment here are not likely to persist indefinitely. And should the investment flow reverse direction, the results—as with any withdrawal from addiction—could very well be painful.

The most immediate consequence of lessened availability of foreign savings would be that an enlarged portion of the U.S. government's deficits would have to be financed from domestic savings. That would reduce the residual available to private-sector participants in credit markets and would tend to accentuate upward pressures on interest rates, with all the likely attendant adverse consequences. Most important, with a sudden cutback in foreign savings inflows, the challenge of sustaining healthy growth in capital formation would be magnified.

What to do

The probable consequences of continuing massive federal deficits are sufficiently grim that it is inconceivable that Washington will not at some point face up to its budget responsibilities. The question is whether actions will be taken in a reasonably timely way or only after deteriorating conditions in financial markets force a recognition of the consequences of budgetary drift. The cynical view—heard almost everywhere—is that leaders in neither political party are likely to be willing to tackle the tough issues of expenditure reduction and/or tax increases until after the 1984 election. Unfortunately, by that time the Treasury will have added several hundred billion dollars to the federal debt. The nation will pay very dearly for that kind of escapism—the price being a variety of negative long-term effects on the economy that are bound to flow from interest-rate levels significantly higher than they otherwise would be.

Opinion leaders, businessmen, and others have a growing responsibility to argue for a change in "politics as usual" in Washington by pointing up the potential problems such politics creates. The unfortunate reality, even at this late hour, is that it is probably still premature to focus very much on the specifics of remedial action. First, a need for action has to be perceived. The important thing now is to raise the level of political sensitivity to that need.

Economy Watch

THE recovery remains vigorous and has become increasingly broad-based. Homebuilding and reduced inventory drawdowns —previously the mainstays of the recovery— contributed significantly to the brisk rise in real GNP in the second quarter. But so also did a surge in consumer spending. And business capital outlays rose in real terms for the first time in six quarters.

Continued strong growth in real GNP— probably over 8% per annum again this quarter—seems assured, given the further rises in production and employment last month (table on this page). In addition, the July tax cut will help to maintain the strength of consumer spending. Inventory building is also likely to boost output, as business adjusts stocks to the new higher level of final demand.

While the strength of the recovery has been a surprise to most analysts (in January, the 40 economists that make up the Blue Chip Consensus expected a real growth rate of only 4.4% on average in the second and third quarters), it is no surprise when compared with that of past recoveries. Industrial production, for example, rose 8.2% during the first seven months of the current recovery (from November to June)—faster than in three previous upswings of the post-World War II period and slower than in the four others (chart on page 7). Other indicators of overall activity, such as employment, show a similar "normal" pattern.

The factors that had been expected to produce a subnormal rebound have proved less potent than anticipated. Earlier in the year, the surprise was the strength in housing—a sector that was expected to recover but at a muted pace in the presence of still high borrowing costs. Most recently, the major surprise has been consumer spending, which in the second quarter rose at an annual rate of 10% in real terms—the largest quarterly increase in almost 20 years.

Tracking the consumer

Until March, consumption had shown little vigor. Christmas buying was lackluster, and sales improved little in January and February. Thereafter, however, spending began to rise sharply: Between February and June, consumption expenditures rose at an annual rate of 16.5%, compared with a rate of increase of only 5.7% in the previous four months.

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983				*1984*
	Q1	*Q2*	*Q3*	*Q4*	*Q1*
Real GNP	2.6	8.7	8.2	4.3	4.4
Real consumer spending	2.9	10.0	5.2	4.9	3.7
Real business-capital outlays	−1.5	4.8	5.8	6.8	7.0
GNP deflator	5.5	4.5	3.8	4.2	4.5
Consumer prices	−0.4	4.2	4.3	4.6	4.9
Real disposable personal income	2.9	2.9	11.5	4.6	1.9
Saving rate (%)	5.4	3.9	5.3	5.2	4.8
Housing starts (Millions)	1.7	1.7	1.8	1.7	1.7
Auto sales (Millions)	8.4	9.2	9.7	9.8	9.9
Unemployment rate (%)	10.4	10.1	9.4	9.1	9.0

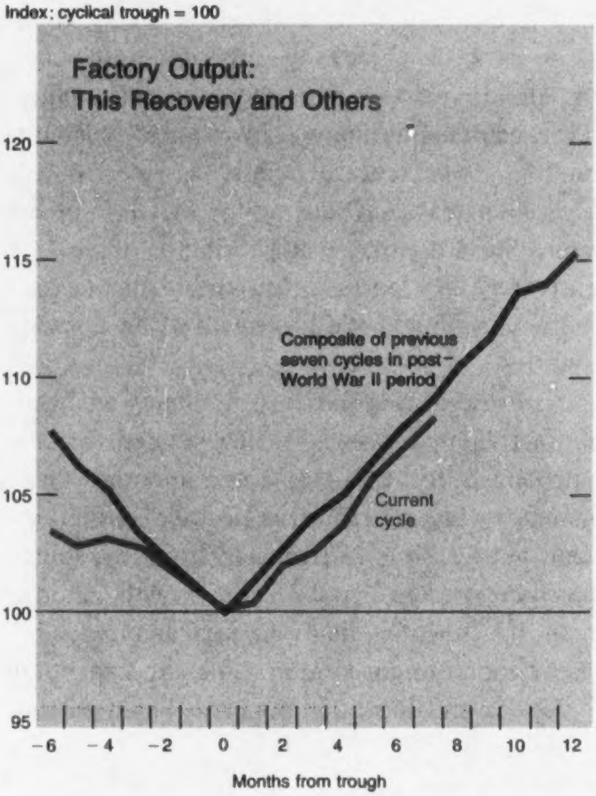
Note: 1983 Q1 and Q2 data are actual.

Significantly, the pickup in consumer spending was not touched off by more rapid income growth. In fact, real disposable income rose at an annual rate of only 2.9% in the second quarter, the same rate of growth as in the first quarter. Thus the entire acceleration in real consumer spending, from 2.9% to 10.0% at an annual rate, reflected a reduction in the saving rate from 5.4% to 3.9% (chart on page 8). That was the lowest reading for the saving rate since 1950.

The switch by consumers to a more aggressive approach is borne out by sentiment surveys. The index of consumer confidence compiled by the University of Michigan, for example, was little changed from October to February (moving only from 73.4 to 74.6). By May, however, the index had jumped to 93.3, and it remained over 90 in June—readings not seen since 1977.

A basis for stronger consumer buying had been developing for some time as household balance sheets improved. Low consumer borrowing since 1980 had reduced installment debt outstanding as a percent of disposable income from a peak of over 18% to only 15% by early this year. In addition, rising stock and bond markets had put consumer net worth on an upward trend since last summer.

What apparently triggered the relatively sudden rise in confidence and spending, however, was the unexpectedly good performance of the economy in the first few months of the year. The employment report released in February showed the first drop in joblessness in a year and a half, and confirmed that economic recovery was under way. Declines in key inflation measures were also reported, underscoring the progress that had been made to contain prices. In addition, borrowing costs continued to fall—with mortgage rates declining almost a percentage point during the first three months of the year, and auto-loan rates dropping to single digits as manufacturers offered subsidized financing.



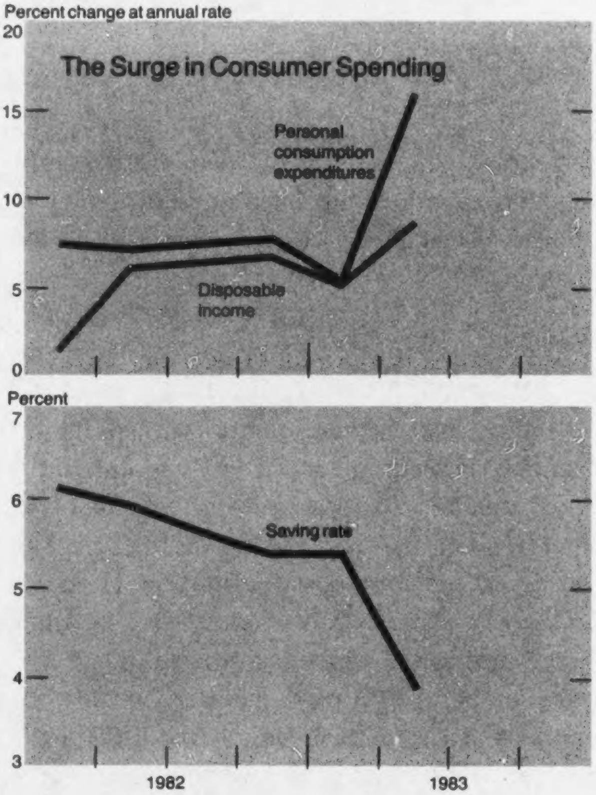
Note: The trough month for this cycle is November 1982, according to the National Bureau of Economic Research.

Slowing ahead

Beyond the current quarter, prospects for economic growth are much less certain. But it is reasonable to expect the recovery to begin to slow as it matures. During the first year of the seven previous post-World War II recoveries, real-GNP growth averaged 7.2%, while in the second year growth averaged only 3.5% (table on page 8). Growth increased in only one of the seven, and that was in the 1971-1972 recovery, which had got off to a slow start.

The elements that are likely to bring about a normal cyclical slowing–probably in the closing months of the year–seem to be in place. Two sectors–housing and inventories–accounted for 3.9 percentage points, or 70%, of the growth in real GNP during the first half of the year. Such a large contribution is typical of early recovery periods, but these sectors normally contribute little to growth as an upswing matures.

Already signs point to a flattening in housing activity, with sales of new homes virtually unchanged for the past three months. Once inventory investment turns positive in the current quarter, little further help from this source can be expected. To be sure, growth in business investment is likely to increase, reflecting the rebound in corporate profits. And spending by states and localities ought to begin to rise, reflecting increased revenues. But improvement in these sectors is unlikely to be dramatic enough to offset a slowing in housing and an end of support from the inventory cycle.



The Surge in Consumer Spending

Real-GNP Growth in Recoveries

(Percent change at annual rate)

Trough	*First year*	*Second year*	*Average of first two years*
1949-Q4	13.3	5.9	9.5
1954-Q2	7.4	2.6	5.0
1958-Q2	8.4	1.7	5.0
1960-Q4	6.4	3.8	5.0
1970-Q4	4.7	7.0	5.8
1975-Q1	6.7	4.4	5.5
1980-Q2	3.5	−1.5	0.9
Average	7.2	3.5	5.3
1982-Q4 (proj.)	5.9	4.1	5.0

A second factor that will contribute to a slowing in growth is the increase in interest rates that has occurred during the past two months. Short-term rates (for example, the Federal funds rate, the rate on large CDs, and the prime lending rate of banks) are all above their recession-period lows–by a minimum (in the case of the prime) of half a percentage point. Long-term interest rates have risen even more dramatically. The rate on newly issued, AA-rated, utility bonds fell to a low of 11% in May, but currently is back over 13¼%. Mortgage rates also have risen sharply, with the rate on government-insured mortgages rising to 13½% from 12%.

Upward pressure on interest rates is coming from a number of sources. A key factor, of course, is the prospect of continuing large budget deficits (story on page 1). Stronger-than-expected economic growth, moreover, has generated concern that private credit demands will begin to rise rapidly. A final—and, indeed, highly important—influence making for higher interest rates has been a slightly less accommodative monetary policy.

Rapid growth in the monetary aggregates was a factor in the tightening of policy and may well be critical to interest-rate movements in coming months. The narrow money stock, M1, has continued to run above target, despite recent upward revisions by the Federal Reserve in both targeted growth and the base from which growth is calculated. The importance of M1 in monetary policy, it is true, has been downgraded because of the rapid growth in interest-bearing NOW and Super-NOW accounts. However, M1 is not being discounted entirely—a point reiterated by Federal Reserve Board Chairman Volcker in recent testimony.

Tentative indications are that M1 growth may become less of a problem in coming months. In the second quarter, the velocity of M1—the rate at which money "turns over"—rose slightly, after a year and a half of surprisingly sharp decline. Whether the recent rise in the velocity of M1 represents a fundamental change in direction (possibly related to the end of the initial adjustment to the introduction of Super-NOW accounts in January) is hard to tell. Even a small further increase in M1 velocity, however, combined with upward revision of the high end of the M1-growth target to 9%, could bring M1 within target in the latter half of the year.

The broader aggregates, M2 and M3, have been less of a problem. Moderate growth in July appears to have them both well within their respective target ranges. Furthermore, on the basis of historical relationships, the rise in interest rates would help to keep growth in M2 and M3 moderate in coming months.

There is some question, however, whether the negative relationship between interest rates and the broader aggregates will hold in this cycle. That is because assets that yield their owners market rates of interest, such as money-market deposit accounts and money-market mutual fund shares, constitute an increasingly large share of the broader aggregates. There is not the incentive to reduce holdings of such assets—as there is with traditional savings balances—when rates rise. Interest crediting, too, adds to growth in these deposits when interest rates rise. Thus, it is not clear that M2 and M3 will be restrained much by the rise in rates.

The impact of the recent rise in interest rates is already evident in a drop in applications for mortgage loans. More critical, perhaps, is the potential impact of higher rates on consumer spending. The recent reduction in the saving rate and the associated surge in consumption appear to have been significantly conditioned by confidence in continued improvement in the economy and in job security and financial well-being. To the extent that the recent rise in borrowing costs leads to reconsideration of these assumptions, a more cautious spending approach by consumers is likely. That is particularly so because of the abnormally low personal saving rate that emerged in the second quarter.

The rise in interest rates has probably not yet gone to the point where it threatens any more than a slowing in the recovery's growth pace. Forward momentum for the present is strong, and the existence of a substantial backlog of demand for consumer durable goods and for housing, built up over an extended period, should be an important sustaining influence. Uncertain prospects for money growth, however, underscore the possibility of further increases in interest rates and more of a slowing in the recovery's pace.

Flexcomp: The New Trend in Employee Benefits

THE latest innovation in employee benefits is flexible compensation—a new type of employee benefit plan that allows workers to choose from a bundle of benefits and, in some instances, take cash if they prefer. Called flexcomp for short, it is being hailed by benefit experts as "the compensation package of the 1980s."

Typically, the benefits from which employees can pick and choose supplement a core of fixed benefits that afford such basic protection as pension, disability, and life insurance. Options might include medical coverage, dental insurance, vision and hearing care, legal services, dependent care, extra vacation, and deferred compensation.

Part of the appeal comes from a major incentive provided by the federal government: Under legislation passed several years ago, the value of the benefits is, within specified limits, nontaxable income to employees. As a result, a "price" can be put on each of the optional benefits, and employees can "buy" the ones they want with company credits or pretax earnings. Flexcomp also appeals to employers because it can help control soaring benefit costs.

So far, only about 40 companies have adopted flexible compensation plans. But a growing number of firms, including The Morgan Bank, are planning to do so.

Spurs to flexibility

A major impetus for flexcomp has come from changes in the composition of the work force. When benefit plans began to take shape 30 years ago, the typical employee was a man with a wife and children at home, and companies designed benefit packages to meet his needs. Those packages generally came to include pensions, medical, disability, and life insurance, with perhaps some ancillary coverages.

Now, however, that once-typical employee accounts for less than 10% of the work force. The balance are working couples, with or without children at home, and singles, some with children. The increased diversity has brought changing needs that traditional plans often do not meet. Working couples may have superfluous medical insurance for instance, but lack desired coverage for, say, child care. Single people may have life insurance they do not need. Business, for its part, spends money on benefits that often go to waste, while employees clamor for a wider range of coverages.

Many companies, however, cannot afford to provide an ever-broadening array of benefits, since with traditional plans employers usually pick up all or most of the cost of new coverages. In recent years, in fact, concern about rising benefit outlays has led many managements to look for ways to contain costs. Some have cut back on existing benefits, frozen new ones, or required employees to pay a larger share of such coverages as medical insurance. Costs of medical coverage have been rising particularly rapidly (the increase in medical-care prices during the past 10 years outpaced the increase in prices generally by 27%) and are a prime target for control in many firms. But cost-containment measures are unpopular with employees and often do not make much of a dent in total benefit outlays.

The basic problem is that, with most benefit spending subject to automatic escalation, costs have been rising much more rapidly than wages. Between 1961 and 1981, according to the United States Chamber of Commerce, average benefit costs per employee rose 70% faster than average earnings; during the same period, such costs rose to 37% of payroll from 25%. If past trends continue, moreover, the latter ratio will rise considerably higher during the 1980s.

An early model

A forerunner of today's elaborate flexible compensation plans was adopted by TRW's Defense and Space Systems Group in the early 1970s. It offered choices as to life insurance and medical benefits, allowing employees to take more or less coverage than had previously been provided. If the employee chose to take less, the difference was paid in cash. If he took more, he paid the difference through payroll deductions. Somewhat earlier, a few companies had pioneered cash or deferred compensation arrangements, under which employees could defer all or part of profit sharing allocations into a qualified trust.

Such innovations, however, largely came to a halt with passage of the Employee Retirement Income Security Act of 1974. One section of ERISA in effect banned new plans offering choices between taxable and nontaxable items until Congress decided whether to rewrite the rules. A grandfather clause protected existing plans.

Then, with a number of firms urging clarification of the law, Congress established a new legal framework by amending the Internal Revenue Code in 1978. Section 125 of the code permits firms to offer packages that include taxable benefits (such as group-term life insurance in excess of $50,000), nontaxable benefits, and cash. (Such packages often are called "cafeteria" plans.) Section 401(k) authorizes choices between cash and deferred compensation. Moreover, the two types can be integrated, so that deferred compensation can be a benefit under Section 125 plans. A key requirement is that such plans not discriminate in favor of highly paid employees.

The amendments have spurred fresh activity, though companies still face uncertainties in setting up flexible plans because the Internal Revenue Service has yet to issue regulations. Proposed regulations for Section 401(k) plans are expected to be made final later this summer, but regulations for Section 125 plans are not expected any time soon. Even so, a number of firms have gone ahead, making "good faith" efforts to comply with the intent of the law and further developing the flexible concept. Today, the most up-to-date models center on letting employees opt to take nontaxable benefits–including deferred compensation–instead of taxable cash.

That model is illustrated by PepsiCo's "Benefits Plus" program. It began modestly in 1980, with the initial choices limited to health care. Options included three medical plans, two dental plans, a vision and hearing plan, and cash. Later the company expanded the program to add a fourth medical option, and include disability, accident, and life insurances. In the early years of the program, employees paid for their share of desired benefits with after-tax dollars.

Now, however, with new features introduced this year, employees select the benefits they want and total the cost. If that is smaller than the company contribution, the employee gets a refund as additional salary. If the total cost is larger than the company contribution, the employee pays the difference from so-called Choice Pay–$3,000 of before-tax earnings put aside in a special account. Any portion of that amount used to pay for benefits is exempt from federal income and Social Security taxes and from most state and local taxes. Any portion not so used goes into taxable salary. The $3,000 salary "reduction," significantly, does not affect pension and other benefits based on salary; they will continue to be figured on gross salary. (The box on page 13 illustrates how PepsiCo's plan can increase an employee's spendable income.)

In addition, employees can choose to put up to 8% of before-tax earnings into PepsiCo's Long Term Savings Program, again without affecting pension and other salary-related benefits. The savings results in a deferral of income taxes. The principal and investment returns accrue tax-free until retirement, age 59½, or termination of employment. Favorable tax rules may then apply–for example, 10-year averaging.

Some drawbacks

PepsiCo, like other companies setting up flexible plans, faced an administrative hurdle. Typically, firms have to educate employees about their choices and the tradeoffs involved. Firms also need a more extensive record-keeping system than with traditional plans, in order to keep track of the coverages each employee has selected. And if a plan includes choice-pay or reimbursement accounts, an accounting system is needed to handle payments from those accounts. Gearing up for flexcomp thus takes considerable effort and imposes a sizable initial cost. Considerations such as these–particularly concern that record-keeping and accounting would be a nightmare–have deterred many companies from introducing flexible compensation.

Another concern is that employee choice will result in "adverse selection"–that is, that the people choosing a dental plan, for instance, will be mainly those needing major dental work. Adverse selection cannot be eliminated, but benefit experts point to ways a plan can be designed to attract people with good teeth by covering preventive and ordinary work more fully than major work. Another method of spreading risks is to require an employee who takes medical insurance for his whole family to cover the whole family for dental care as well –or vice versa. In some cases, firms have reduced selective use of a dental or other plan by requiring employees who do not sign up for coverage when first eligible to wait two years before enrolling.

In other cases, a firm can let adverse selection work for it. A number of companies with multiple medical plans are doing just that. The healthiest employees tend to choose the cheapest plan, and those with health problems, the most expensive. With each plan priced according to experience, the premium for the plan attracting the less healthy rises faster than the other premiums. As the costs of the options diverge, price considerations encourage some employees to trade down to a less expensive plan. The organization ties its contributions to the more slowly rising cost of the cheapest plan. Thus as the cost of the high-priced option increases more rapidly, employees keeping that option pay for a larger portion of the total cost.

Regulatory uncertainties

For many companies, perhaps the major stumbling block in taking the flexible approach is uncertainty about how to comply with the law. In the absence of regulations, firms going ahead with flexible plans take a calculated risk that their good-faith efforts will put them in compliance. But many firms shy from that risk. Presumably, however, once the regulations are issued, this deterrent will disappear, and the stage will be set for an increase in the number of companies adopting flexcomp plans.

As yet, no one seems to have attempted a calculation of what flexible compensation plans would cost in terms of reduced tax revenues. A major difficulty in making such estimates, of course, is that no one can confidently predict how quickly–and how widely–the new approach will catch on among companies.

Historically, in allowing generous tax treatment for employee benefits, Congress has implicitly reasoned that the Treasury's revenue losses were offset by social gains. Employer-paid pensions and deferred compensation, for instance, were thought to contribute to employees' financial security in later years, while coverage for medical care enhanced the health of the work force.

With the federal budget now in deep deficit, tax preferences for employee benefits seem certain to be kept under review in Congress, perhaps leading to another set of ground rules. Some observers suggest, for instance, that, as plans proliferate, Congress will be tempted to put caps on the dollar amount or percentage of before-tax earnings that employees can defer or use to pay for benefits.

But that may be some time off. In the meantime, flexible compensation offers companies a way of paying people that usually yields more employee satisfaction per dollar of compensation than do traditional plans. It also heightens employees' awareness of the value of benefits. With these now accounting for over a third of payroll on average, that is an important business consideration.

Adoption of flexcomp is thus likely to grow. Congress as a matter of prudence will have to keep costs to the Treasury under continuous review, but it is reasonable to think, in the light of broad efficiency considerations, that this latest innovative development in benefit programs has a promising future.

BENEFITS THAT BOOST SPENDABLE INCOME

PEPSICO's Choice Pay plan can increase an employee's spendable income.

For example, take a worker with a gross salary of $25,000 a year who is married and files a joint return. Disregarding state taxes, the worker's after-tax income would be as follows:

Taxable salary	$25,000
Federal and Social Security taxes	–$5,800
After-tax earnings	$19,200

Now assume that the worker chooses benefits coverage that exceeds PepsiCo's contributions by $600. In the past, the worker would have contributed the $600 for benefits through payroll deductions. The worker's spendable income would have looked like this:

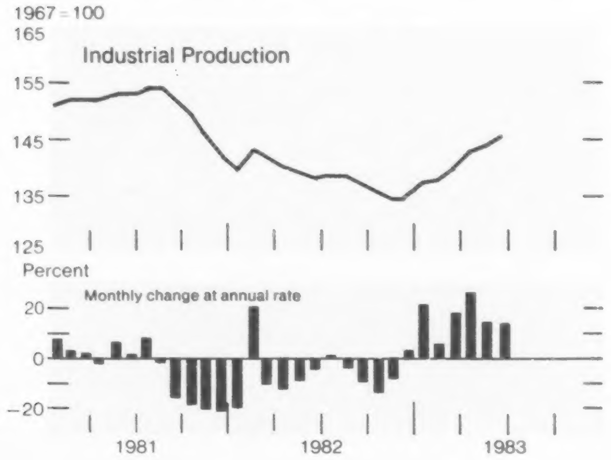
Earnings after taxes	$19,200
Benefits plus contributions	–$600
Spendable income	$18,600

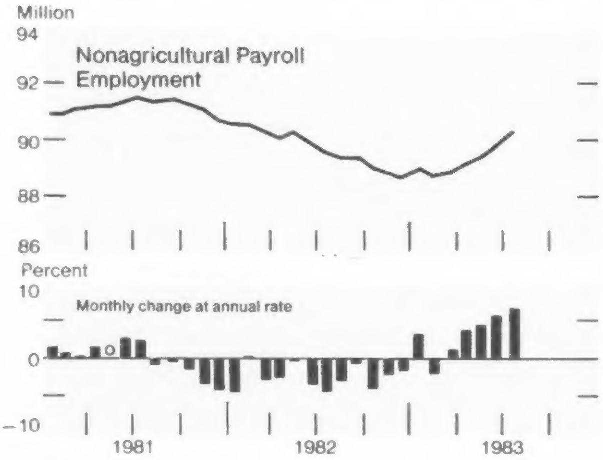
Beginning in January of this year, the Choice Pay program allows the worker to contribute toward the same benefits using pretax earnings. The result :

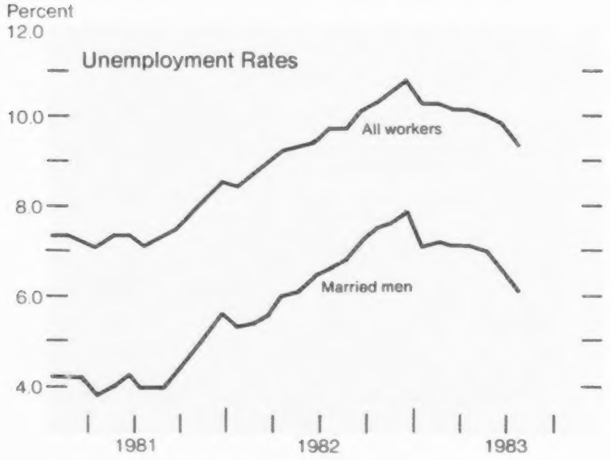
Salary	$25,000
Benefits plus contribution	–$600
Taxable salary	$24,400
Federal, Social Security taxes	–$5,500
Spendable income	$18,900

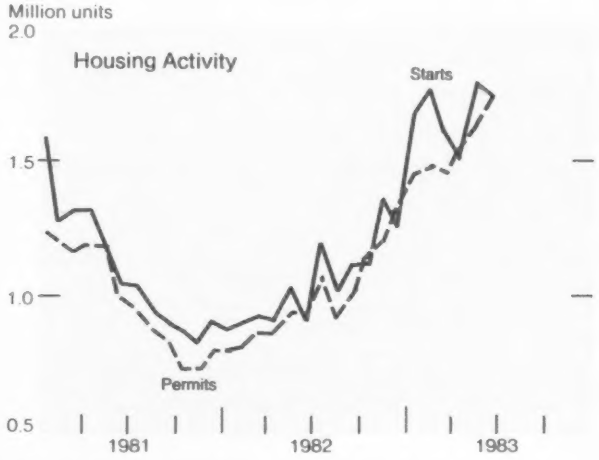
By purchasing benefits with pretax dollars, the worker's spendable income increases to $18,900 from $18,600. Taxes for the year are reduced by $300.

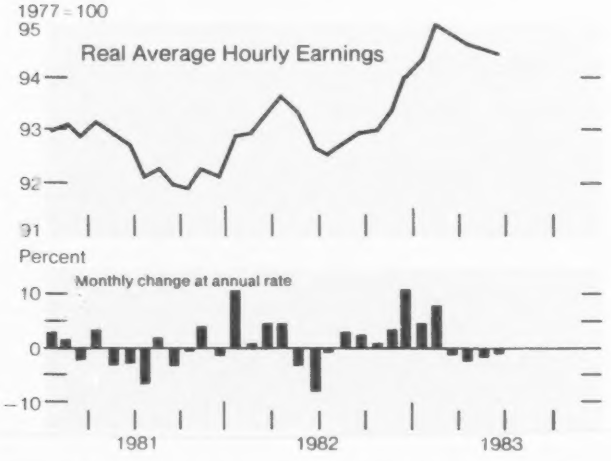
ECONOMIC INDICATORS

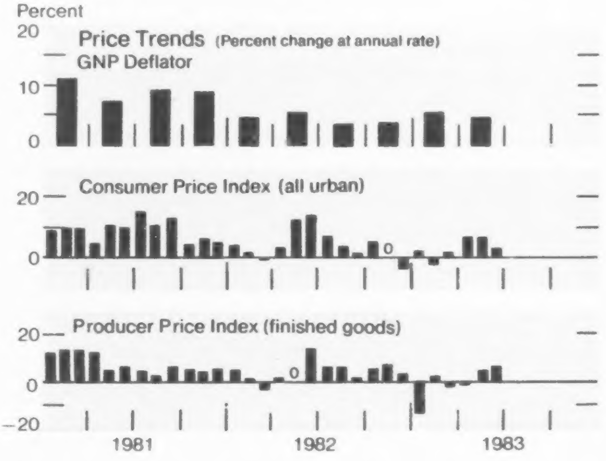






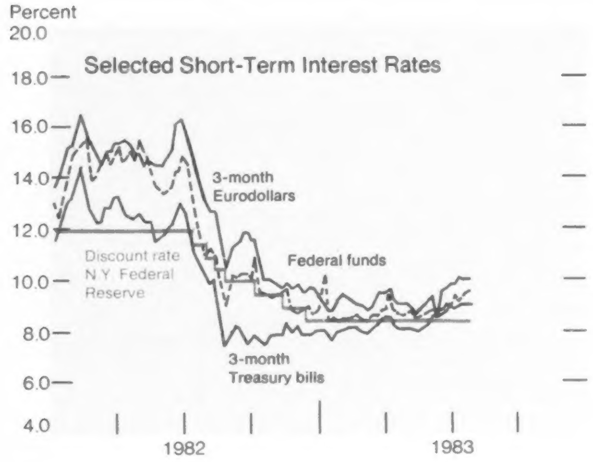


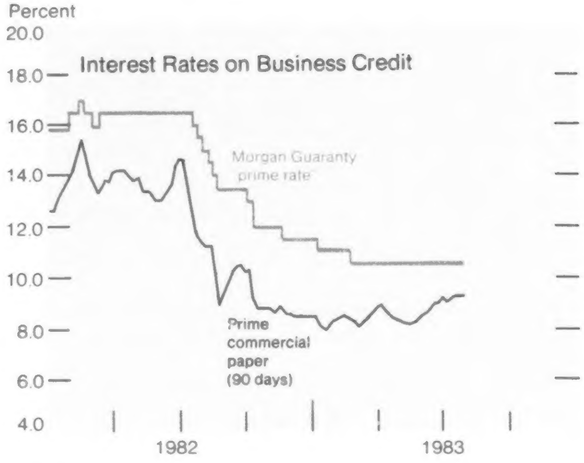


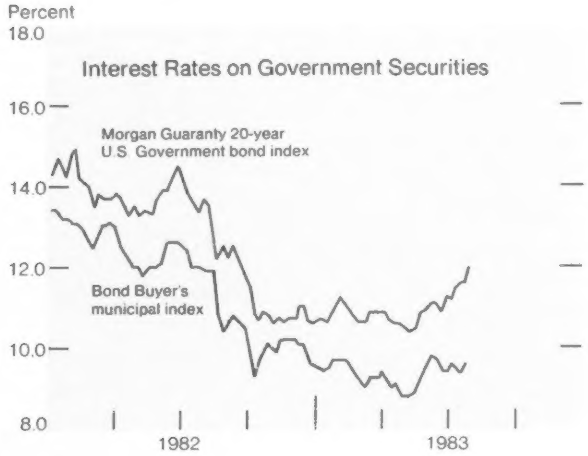


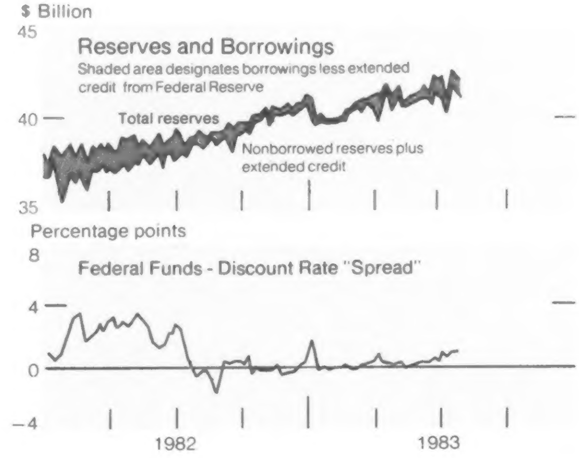
Note: All data are seasonally adjusted. Hourly earnings are adjusted for overtime in manufacturing and for interindustry employment shifts.

MONETARY INDICATORS


Selected Short-Term Interest Rates

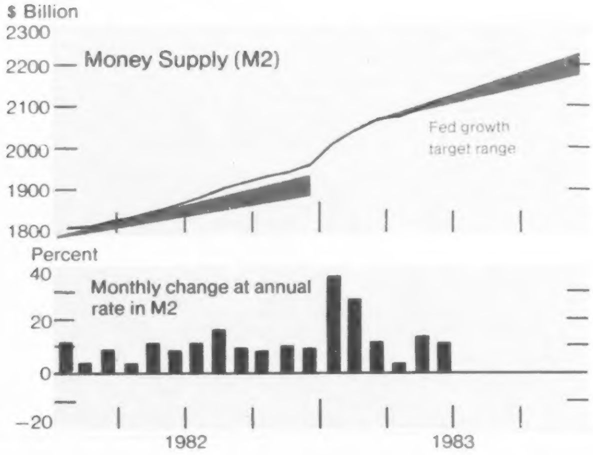

Interest Rates on Business Credit


Interest Rates on Government Securities

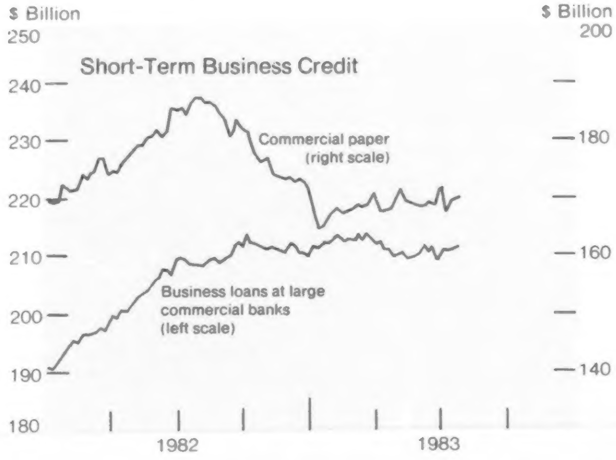

Reserves and Borrowings

Shaded area designates borrowings less extended credit from Federal Reserve

Federal Funds - Discount Rate "Spread"


Money Supply (M2)

Monthly change at annual rate in M2


Short-Term Business Credit

Note: M2 equals M1 plus overnight RPs and Eurodollars, general purpose and broker/dealer money market fund balances, money market deposit accounts, savings and small time deposits (net of IRA/Keogh balances). The 1983 M2 growth target is measured from an average February - March base. Business loans are net of bankers' acceptances. All data except interest rates and member bank borrowings are seasonally adjusted.

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SEPTEMBER 1983

Whither Wages? *Many analysts look for a new wage spiral as profits rise, the recovery widens. But a case can be made for a fundamental slowdown in pay increases.* 1

Economic Outlook. *The recovery keeps rolling along, even though the earlier exuberance is fading. A more subdued pace would hold positive implications for credit markets. Latest economic projections, quarter by quarter.* 4

Fed Watching. *What's the Federal Reserve up to? An understanding of Fed operations in securities markets can provide clues. A guide to the Fed's operating techniques.* 6

Economic Indicators 11

Wage Inflation: Speedup Ahead?

AFTER a dramatic slowdown in this country's wage inflation, the big question is: Will the recovery trigger a renewed wage spiral?

The index of average hourly earnings has risen at an annual rate of 3.8% so far this year. That compares with a peak rate of increase of close to 10% in 1980 and a rise of 6% as recently as last year (chart on page 2). This year's wage-increase pace is the lowest since the mid-1960s. With labor costs accounting for two-thirds of total costs, the wage slowdown has played a big role in the remarkable waning of inflation.

Now many analysts feel that wage restraint is about over. The consensus is that wage-rate increases will soon start climbing and could reach a 6% pace next year. But there are a number of reasons to be more optimistic. Indeed, in today's competitive environment, wage increases seem likely to continue to be moderate.

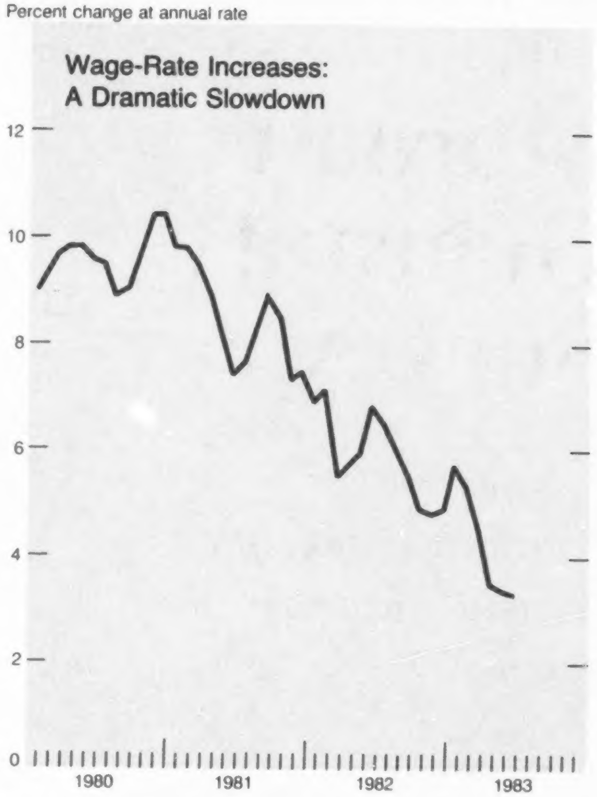
Fundamental slowdown?

The normal cyclical pattern is for wage rates to respond to recovery with a lag–and then only relatively mildly. As a consequence, wage-rate gains tend to continue to decelerate for the first year or so of a business cycle expansion and then to be relatively stable during the second year. If this pattern were to be repeated in the current cycle, wage-rate increases would run in the 3%-to-4% range in 1984. Such an outcome would have dramatically different implications for inflation and for interest rates than would the consensus view of 6% wage-rate growth.

On the face of it, there is little reason to expect a more rapid than normal pickup in wage rates. In the current cycle, changes in the unemployment rate are closely following the normal cyclical pattern. And the level of unemployment is higher, and is expected to stay higher, than at the same point in any previous post World War II cycle. Those who foresee a speedup in the wage spiral maintain that past patterns in wages do not apply because of the unusual severity of the recent recession. Plunging profits, soaring bankruptcies, and mounting layoffs created an environment in which it was possible to achieve significant reductions in labor costs. Consequently, it is argued, wage increases could accelerate rapidly during the recovery as the fear of bankruptcy and job loss fades and workers seek to recover some of what they lost during the recession. The example often cited in support of this view is Chrysler Corporation. Wage rates were cut during the recession when it appeared that the company might go bankrupt, but with a recovery in profitability the union is already calling for a restitution of these cuts.

But there may be more behind the wage-rate slowdown than just recession-induced wage concessions in distressed industries. The downward pressure on wages has been pervasive. Almost 50% of the workers covered by collective bargaining contracts negotiated in the first half of this year received no specified wage increase for the duration of the contracts or accepted outright wage cuts. Many of these workers were in industries that were not severely hit by the recession.

Industry-by-industry analysis suggests that heightened competitive pressures lie behind the wage-rate slowdown. Quite aside from the effects of the recession itself, increased competition–from other U.S. companies as well as from foreign producers–has focused corporate attention on costs, particularly wages.



Wage-Rate Increases: A Dramatic Slowdown

Note: Index of average hourly earnings, adjusted for overtime in manufacturing and interindustry employment shifts. Percent changes are from three months earlier at a compound annual rate. A three-month moving average of the index is used to reduce the month-to-month volatility.

In the past, wage-rate levels in many industries were not a major concern. Industry-wide wage patterns often meant that individual firms paid the same wage rate and thus did not have to worry about being at a competitive disadvantage. In many cases, however, such uniformity can no longer be taken for granted.

Deregulation's role

The deregulation of such industries as trucking and airlines has dramatically changed the wage-setting process. Before deregulation, these industries maintained industry-wide wage patterns that prevented wage rates from playing a role in competition between firms. With the entry of new firms with different wage-rate levels, however, industry-wide patterns have broken down. Indeed, wages in both the trucking and airline industries, which in earlier years had typically risen, on average, more rapidly than the broad trend of wages, have actually declined this year.

Another industry that is facing deregulation is long-distance telephone service. The impact of progressive deregulation is already evident in the new AT&T labor contract. The fact that AT&T will be facing increasing competition from firms with significantly lower labor costs contributed to the relatively modest settlement reached last month. As long as AT&T had a monopoly and could routinely pass along higher costs to its customers, it had little incentive to hold down wage costs.

The entrance of new firms–many benefitting from newer technology and nonunion labor–has triggered wage competition in a number of industries. Meatpacking is a good example. In the past, an industry-wide wage pattern allowed a relatively high wage-rate level to develop. Now, however, the entry of newer firms, that have not adhered to the industry-wide wage pattern, has undermined that uniform wage structure and introduced competition into the wage-setting process. The result has been substantial cuts in wage levels in the industry.

Although the example of meatpacking is unusually dramatic, there are many similar cases –particularly in construction–of increased domestic competition affecting the wage-setting process.

Increasing foreign competition is changing the competitive environment in a broad range of industries. Many firms that previously had only to worry about three or four domestic competitors now face stiff competition from world producers. And the foreign firms often enjoy lower wage and other costs.

Heightened foreign competition with American companies shows up in U.S. trade figures. While in 1970 merchandise imports and exports amounted to less than 10% of U.S. output, by 1981 they each amounted to almost 20%.

Not only has the volume of trade expanded, but the range of goods being traded has grown. Japan, of course, has become the premier manufacturer of high-technology consumer and capital goods and is providing stiff competition in many industries. Developing countries in Asia, such as Taiwan and South Korea, have dramatically expanded the range of goods they produce and sell in world markets.

In the past two years the rise in the value of the dollar on foreign exchange markets has further increased the pressure from foreign competition. The higher dollar has reduced foreign manufacturing costs by approximately 25% in dollar terms relative to costs in the U.S. This has forced U.S. firms to focus on becoming more-efficient and lower-cost producers.

Chilling winds

All sectors of the economy, of course, have not felt the chill winds of intensified competition. And it is in exactly those areas, most notably utilities and state and local governments, that wage-rate increases have shown the least tendency to slow.

Still, the evidence of the past two years suggests that fewer and fewer companies are immune to wage competition as the effects of deregulation grow and foreign competition becomes more intense.

Those trends seem likely to continue. This raises the possibility that, even as the recovery gathers momentum, the moderate character of wage-rate increases may continue to surprise analysts. If the rate of wage increase were to stabilize below 5%—a distinct possibility in today's competitive environment—those analysts predicting a cost-induced acceleration in inflation to 6% or more in 1984 could turn out to be significantly wide of the mark.

Economy Watch

REAL GNP this quarter should show another large gain. The momentum going into the quarter was extraordinarily strong, and it continued into early summer judging by a broad range of output-related measures.

Sales, however, are advancing less robustly than they were a few months ago. Clearly, a significant part of the growth in output is now being channeled into inventories—a welcome development since stocks in many lines had fallen to very low levels. By early fall, when inventory rebuilding should be fully under way, the rise in production is likely to moderate. The Morgan Bank's forecast is for nearly a halving in real GNP growth in the fourth quarter (accompanying table).

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983				1984
	Q1	*Q2*	*Q3*	*Q4*	*Q1*
Real GNP	2.6	9.2	8.2	4.3	4.4
Real consumer spending	2.9	9.7	4.1	4.8	3.9
Real business-capital outlays	−1.5	6.1	8.4	6.7	7.1
GNP deflator	5.5	3.5	4.5	4.0	4.6
Consumer prices	−0.4	4.2	4.4	4.7	4.9
Real disposable personal income	2.9	3.3	7.4	4.5	1.9
Saving rate (%)	5.4	4.0	4.8	4.7	4.3
Housing starts (Millions)	1.7	1.7	1.8	1.7	1.7
Auto sales (Millions)	8.4	9.2	9.5	9.8	10.1
Unemployment rate (%)	10.4	10.1	9.4	9.1	9.0

Note: 1983 Q1 and Q2 data are actual.

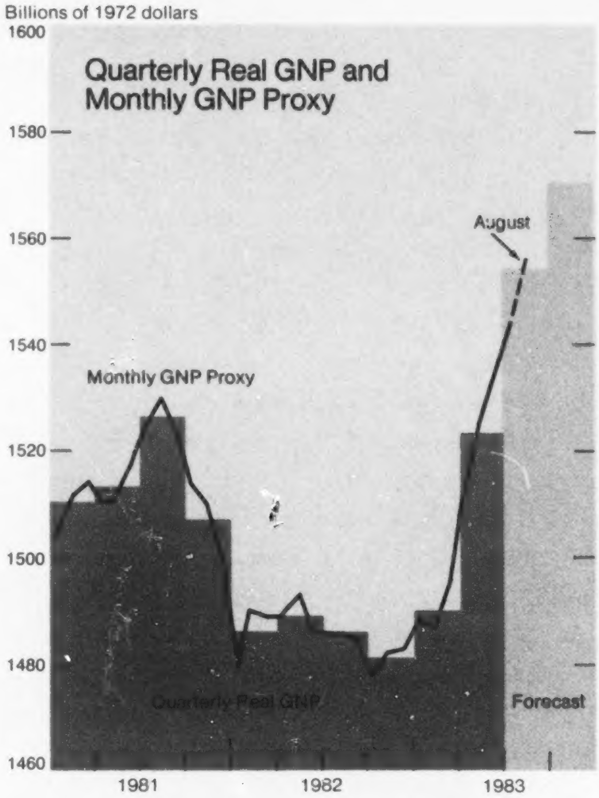
This, of course, assumes that the much slower pace of growth in consumer spending that has emerged recently continues. Both auto and nonauto sales have eased, following the burst of spending in the spring. And this has been the case despite the spur to spendable income provided by the July tax cut.

Reasons for the moderation in sales activity are not entirely clear. A contributing factor in the case of autos has been the shortage of popular models. In addition, in the past month Detroit has been testing the market without as much reliance as formerly on rebates and other sales incentives.

Significantly, however, reduced joblessness and upbeat consumer sentiment readings from survey data suggest that the recent flattening in sales should not be interpreted as a retrenchment by the consumer. Rather, it should be read as a pause, coming naturally after the spring surge in buying—one that brought the saving rate down to an unusually low level.

Renewed growth in consumer spending is thus the most likely prospect. But with little room now for any significant decline in the saving rate, the trend of sales activity presumably will reflect the moderate growth pattern evident in personal income. Apart from the tax cut, income has been rising in recent months at an annual rate of only 6½%—with small wage-rate gains muting the impact on income of rising employment (story on page 1).

Some weakening in housing activity also seems to be at hand. The nationwide rise in mortgage rates—from about 12½% in mid-May to 14% today—is starting to make a difference, as evidenced by July's declines in home sales and single-family housing starts. The increased cost of carrying the median-priced house—$80 per month—evidently has been a high hurdle for many. And it will be for others in ensuing months as builders exhaust the last of the permanent-financing commitments they obtained when mortgage rates were lower.



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

Implications for Fed policy

Slower economic growth would be a plus for credit markets. It would lessen the Federal Reserve's concern that the recovery was proceeding too rapidly. At the same time, it would make it easier for the Fed to meet its targets for money and credit, since transactions needs for funds would tend to grow less rapidly than they did in the spring.

That the targets can be met at current interest-rate levels is far from a foregone conclusion. But indications are encouraging. Significantly, the growth of both M2 and M3 has slowed relative to growth earlier in the year. M2 now seems to be gravitating toward the lower end of its target band. M1 remains on the high side—despite recent moderation. But M1 has been relegated to secondary importance as an intermediate target of policy, a point reemphasized by the record of policy actions of the Federal Open Market Committee taken in July.

The more reassuring pattern of money growth that has developed lessens chances that the Fed will feel obliged to tighten policy further in coming weeks. Indeed, what seems most likely now is that the Fed will mark time, waiting for clarification of just how much slowing is in progress in the economy. A confident assessment of economic trends may have to await September figures, however, since upcoming data for August will be distorted by the depressant effects of the nation-wide telephone strike and the storm in Texas. The Fed may well feel that it will need the benefit of the clearer September readings before deciding what to do next.

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How the Fed Plays Its Hand

THE main goal of monetary policy—stable, noninflationary economic growth—is well known. Much less well known, however, are the operating techniques used to implement policy. Yet an understanding of the detailed mechanics of such operations is crucial to interpretation of policy actions.

Fed watching is far from a science. Even those who do it for a living are often puzzled by Fed actions—and often disagree in interpreting such actions. For example, at a particular time some Fed watchers may be expecting monetary policy to tighten, while others are looking for no change in policy. Suddenly, the Fed intervenes in the open market to drain bank reserves. One analyst interprets this action as a signal that the Fed is tightening. Yet another analyst sees the Fed move as unenlightening in a policy sense—merely an offset to seasonal factors that were increasing bank reserves.

Such differences in judgment are frequent. They arise because the principal tool of Fed policy—open market operations (the buying and selling of Treasury and agency securities)—is almost never totally unambiguous to private observers. This article explores some of the hazards of interpreting open market operations.

Setting strategy

The Federal Reserve System's principal policy-making body—the Federal Open Market Committee (FOMC)—sets policy at strategy sessions that are held eight times a year in Washington. Having established policy objectives for growth in the monetary aggregates consistent with its economic goals, the FOMC relies on the Manager for Domestic Operations of the System Open Market Account to supply or drain bank reserves in the appropriate amount to achieve such objectives. It is the Account Manager (operating at the open market "desk" of the Federal Reserve Bank of New York) who decides on a day-to-day basis what open market purchases or sales of securities, if any, to undertake to meet weekly reserve targets.*

Banks, by law, must maintain fractional reserves against deposits. Such reserve requirements are satisfied mainly by holding deposits at the Fed in a "reserve account." Reserves are added to the banking system when the Fed buys securities in the open market—outright or on a temporary basis—and credits the reserve account of the seller's bank. An open market sale of securities has the opposite effect.

The System Account Manager's job is anything but routine. His chief concern is his *dynamic* responsibility—that is, to supply just enough reserves to achieve the FOMC's fundamental policy objectives for money growth and the economy. Much of his energy, however, is directed to *defensive* actions aimed at neutralizing seasonal and random fluctuations in reserves. If not countered, such fluctuations often can cause reserves to deviate significantly from a desired path.

How does the Manager decide whether to add or to drain reserves each week and by how much? First, he consults Fed staff estimates of reserves needed to satisfy FOMC objectives. Then he considers what transitory developments, seasonal or otherwise, might interfere with those goals. Swings in such factors as currency in circulation and Treasury deposits at the Federal Reserve may add to or reduce reserves. For example, currency in circulation typically rises during major holiday seasons, such as Christmas and Easter. At those times, to supply customer needs, banks acquire currency from the Fed, which charges their reserve accounts. Thus, bank reserves are drained. The Fed ordinarily would opt to offset such reserve drains until such time as currency flows back into the banking system after the holidays, enabling the banks to replenish their reserve accounts.

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*The Fed's declared operating focus in controlling reserve availability is nonborrowed reserves—that is, total reserves less reserves that banks have borrowed through the Federal Reserve's discount window. It is really total reserves which determine the capacity of the banking system to generate deposits. However, if the Fed at any point finds itself needing to supply more reserves in total than it wants to (because deposit generation has been proceeding more rapidly than implied by money targets), it can force an adjustment in the lending and deposit-generating activities of banks simply by limiting the supply of nonborrowed reserves.

The Fed also needs to smooth out reserve fluctuations caused by random events. A blizzard, perhaps, sweeps through a wide section of the country, closing airports and impeding shipments of checks in the process of being cleared. Unless the Fed takes offsetting action, delays in check shipments would have the effect of temporarily swelling bank reserves. This is because the checks would take longer to clear than the time schedule by which the Fed automatically credits bank reserve accounts for checks submitted for collection. To prevent an unwanted bulge in reserves, the Fed would customarily engage in temporary draining actions until airport runways are plowed, regular flight schedules resume, and the processing of checks returns to normal.

The Manager is not always able to offset exactly random and seasonal disturbances affecting bank reserves. Particularly when disturbances are large, Fed staff estimates of reserve availability can be wide of the mark. The Manager's defensive open market operations may then be either too big or too small. Such errors sometimes cause Fed watchers to misinterpret Fed intentions.

Moving into the market

As he tries to keep reserves and money growth on track, the System Account Manager's principal tools are purchases or sales of securities involving the System's $150-billion portfolio of government and agency issues. By law, all additions to this portfolio must be from the secondary market rather than directly from the Treasury. System holdings may be redeemed as they mature (or rolled over into replacement issues), but they cannot be increased through purchases of new issues in Treasury financings.

The Manager's basic decision to provide (or to absorb) bank reserves is made concurrently with decisions on other key questions: Should he inject (or absorb) reserves on a temporary basis or in a more permanent fashion? (Staff reserve projections extend several weeks ahead, helping the Manager to interconnect weekly reserve operations.) Should he operate "behind the scenes" or move openly to signal Fed policy intent?

Permanent operations

Sometimes reserve absorption or infusion is related to developments of semipermanent or permanent duration. For example, a Thanksgiving-to-Christmas rise in currency in circulation (a phenomenon that, as noted earlier, drains bank reserves) may necessitate reserve injections for several weeks. Additions to reserves may also be more permanent, aimed at accommodating the economy's growth. Extended seasonal needs and longer-term reserve objectives are usually achieved by outright operations in Treasury bills, coupon, and agency issues.

System outright purchases. Outright purchases in the open market designed to supply reserves occur relatively infrequently. There are no rigid rules regarding which securities may be bought outright. Many considerations affect the choice, including the duration of the reserve need and the size of the transaction in relation to market conditions. Treasury coupon or agency issues are bought occasionally to provide permanent reserves for underlying economic growth.

The Treasury bill market, however, is the "natural habitat" for open market operations. The reasons: the bill market's great size, its ability to absorb large transactions smoothly, and the adaptability of bill transactions to permanent or semipermanent reserve needs. Bill operations give the System Account Manager considerable flexibility. He can buy bills outright, injecting reserves. Weeks or months later, he can roll the bills over at maturity with a neutral impact on reserves. Or, if he should choose, he can redeem or sell the securities to absorb reserves.

System outright sales. If the decision is to drain bank reserves for an extended period or permanently (needs that might arise if there is an unusually large seasonal flow of reserves into the banking system or if monetary growth is considered excessive), the Manager could sell Treasury bills. Although he has the authority to do so, the Manager does not sell coupon issues in the open market. Because coupon issues are added to the System portfolio to supply long-term reserve needs, they are generally held to maturity. If the Manager prefers to keep a low profile in draining reserves, he may simply let securities run off as they mature or sell bills directly to foreign official accounts behind the scenes rather than sell them in the open market.

Temporary operations

Temporary transactions occur more often than do outright operations, partly reflecting the frequency of short-run defensive reserve needs. Day-to-day reserve objectives are usually met with repurchase agreements (RPs), which initially supply reserves, or by matched sale-purchase transactions (MSPs), which initially absorb reserves.

System RPs. In this transaction, the open market desk buys securities* on a self-reversing, temporary basis. That is, the seller agrees to buy the securities back on or before a specified date. System RPs must be for less than 15 days. Usually, however, they are done overnight or for short-term periods of two to seven days. System RPs provide reserves when they are executed and automatically drain reserves when they run off.

System MSPs. Matched sale-purchase transactions (often referred to in the market as "reverse RPs") have a precisely opposite effect to that of RPs. MSPs drain reserves temporarily when they are initiated and provide reserves when they are extinguished. Technically, when the System Account initiates MSPs, it sells securities. Simultaneously, the System Account purchases the same securities for delivery the next day or a few days later.

Customer transactions

The Manager's job of keeping reserves on a desired growth path is complicated by the fact that various foreign official entities (central banks, governments, and international institutions) maintain what are, in effect, short-term investment accounts with the New York Fed.

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*Treasury obligations, certain agency securities, and prime bankers' acceptances.

Substantial dollar totals flow through these accounts each day, with the New York Fed under instructions to keep the bulk of these balances continuously invested in earning assets.* The Manager needs to be careful to integrate movements of funds in and out of these customer accounts (and the associated investment transactions) with his overall reserve strategy. That is because transactions involving customer accounts can have reserve-absorbing and reserve-supplying effects.

For example, an inflow of funds into a foreign-official account will (in and of itself) decrease the reserves available to the banking system. That occurs because the funds moving into the Fed are drawn out of some bank's reserve balance (or out of the reserve balances of a number of banks). The Manager, depending on his reserve objectives at the time, can negate the reserve absorption by buying securities in the open market. Typically this is done by executing a repurchase agreement for the account of customers–a "customer RP." Or he can let the reserve absorption occur by selling securities to the foreign customer from the Fed's portfolio.

A customer RP has the same reserve-supplying effect when executed as a System RP and the same reserve-draining effect when unwound. Although some Fed watchers attach greater importance to System RPs, the choice normally has no policy significance. In general, customer money is used for moderate-sized operations and System RPs are used for larger reserve tasks.

Significantly, though, the Manager's discretion either to invest customer balances in the market or to invest them internally by selling the customer securities from the System's own portfolio imparts a special character to customer transactions. This is because Fed watchers are unaware of internally accommodated customer transactions when they are taking place. Only with a time lag (when the System's balance sheet is published) will the Fed watcher be able to deduce that internal transactions have occurred. By contrast, open market interventions for System Account are immediately visible (although their size is not announced).

The hidden feature of internally accommodated customer transactions drives home the point that there inevitably are major gaps in the knowledge that outsiders have of the reserve adaptations being effected at any given time by the System Account Manager.

The lesson

While the Fed's fundamental policy objectives are straightforward, policy implementation obviously is complex. Open market operations reflect a subtle blend of dynamic policy motives and defensive actions designed to offset seasonal and random reserve flows. Fed watchers attempt to separate out the dynamic policy elements of Fed actions by analyzing how System operations compare with their own weekly forecasts of defensive reserve needs. Monitoring of open market operations thus can provide some clues in gauging Fed policy intent. But the risks of misinterpretation are legion.

Certainly a mechanical interpretation of System Account actions can be misleading. Because Fed strategists must rely on estimates and projections of reserve availability, there is a significant amount of guesswork involved. Indeed, Federal Reserve officials are quick to acknowledge uncertainties and imprecisions. As Paul Meek, Vice President and Monetary Adviser to the Federal Reserve Bank of New York, has cautioned: "Fed watchers have to be on guard against overestimating the certainty of the desk's own knowledge of reserves and money supply growth at the time it operates."*

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*The size of this daily investment pool averages between $1.5 billion and $3 billion.

Moreover, open market operations represent only one facet of the complex, evolving policy process. Recently, distortions in the behavior of the monetary aggregates have posed serious dilemmas for policymakers. Concern has been expressed about how effectively the Fed can constrain the aggregates and about how rigidly money should be controlled when its relationship to the economy seems to have gone astray. The Fed's recent more judgmental and flexible approach to money targeting has led some Fed watchers to wonder whether the central bank's operating strategy has been modified permanently.

In a setting in which policy tactics may be changing, it is crucial that Fed watching not be narrowly construed. Comments by Fed officials, public records of FOMC policy meetings, statistics and policy studies released by the Fed –all of these need to be analyzed for policy hints. But even the most dedicated Fed watchers cannot be sure that they have correctly divined Fed intentions. There is no foolproof way to read the Fed's mind.

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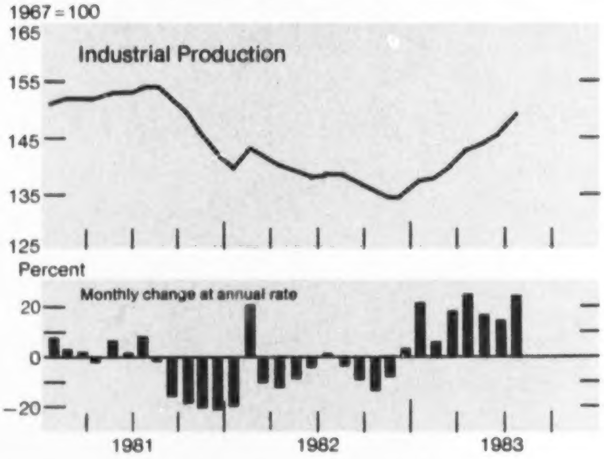
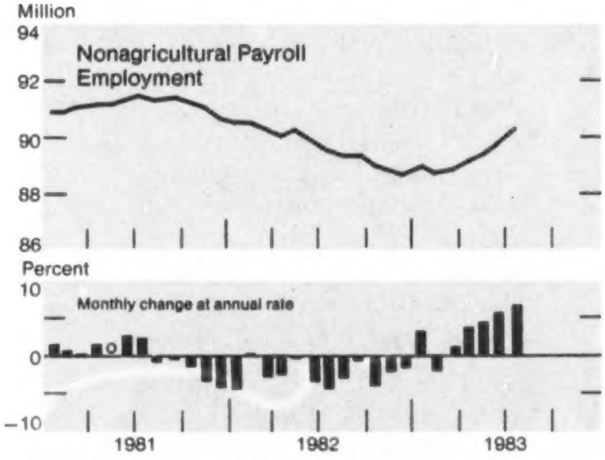
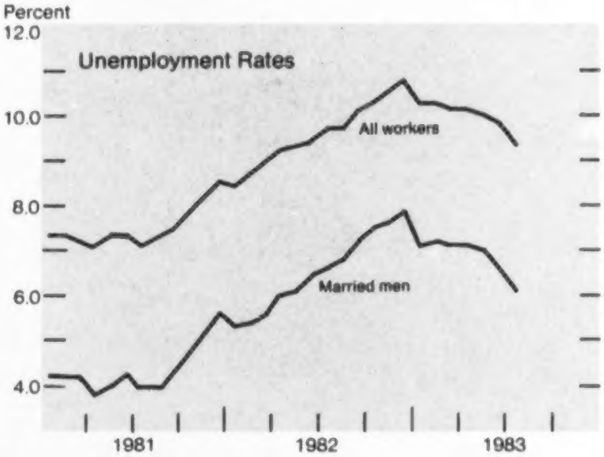
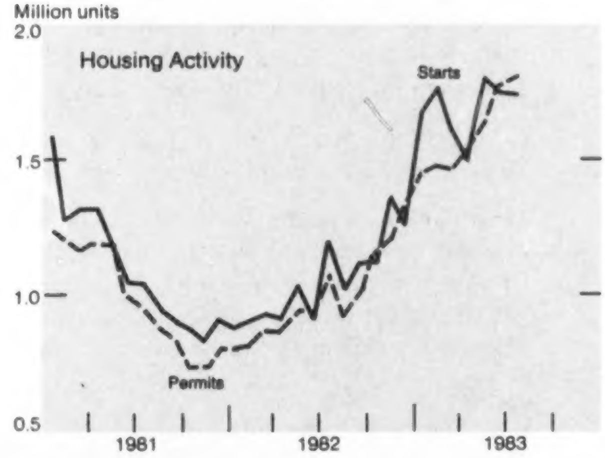
*Paul Meek, *U.S. Monetary Policy and Financial Markets,* Federal Reserve Bank of New York, October, 1982.

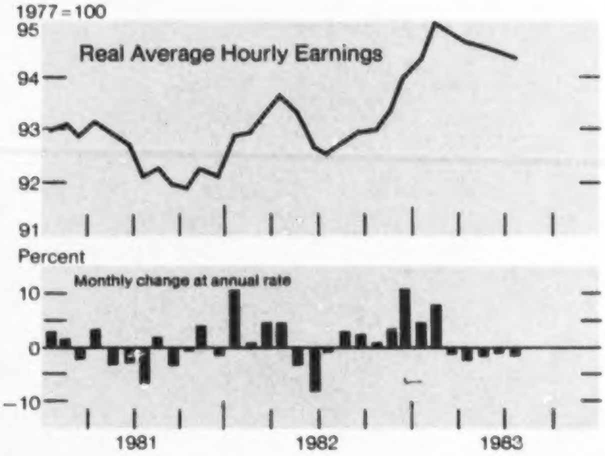
ECONOMIC INDICATORS

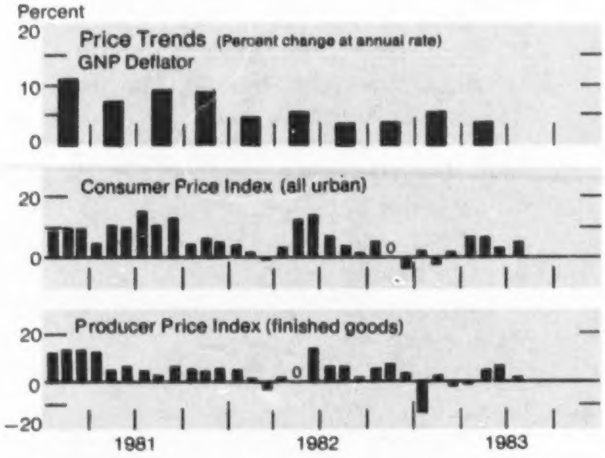












Note: All data are seasonally adjusted. Hourly earnings are adjusted for overtime in manufacturing and for interindustry employment shifts.

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Economic Outlook. *Not surprisingly, the recovery's torrid pace is cooling. But the upbeat goes on. Latest projections, quarter by quarter.* 1

Credit Flows. *Congestion in credit markets, a worry last summer, now seems unlikely well into 1984. Reasons why—and a sector-by-sector analysis of credit demand.* 3

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Economy Watch

THE recovery, as expected, is decelerating. In the past two months, the growth of employment in the nonfarm economy has slowed—rising at an annual rate of 2.1% as compared with 2.9% during the first seven months of the year. The length of the workweek, on average, moreover, has not changed appreciably since late spring.

With a less robust growth pace under way, further progress in reducing joblessness—which by September had moved down to 9.1% from a peak of 10.7% last December—will be harder to come by.* Significantly, inventory investment will contribute much less prominently to growth than it has in the past three quarters. Final demand will lose the support that up to now has come from rapidly growing housing activity, and consumer spending is unlikely to provide the impetus it did earlier this year. Pressures on interest rates, in the process, should moderate. Real-GNP growth through the end of next year, according to The Morgan Bank forecast, can be expected to settle down to around a 4¼% annual pace (table on page 2).

Real consumer spending appears to have grown at an annual rate of only about 2% in the third quarter following the 10% growth rate in the previous three months. A slowing in spending growth is no surprise given the fact that over half of the surge in sales this spring was financed by a reduction in the personal saving rate to a low 4%. In addition, third-quarter sales were depressed by the impact of record-high temperatures on sales of fall merchandise and by the impact of low auto inventories on sales of new cars. The Morgan Bank forecast assumes that consumer spending will pick up in the fourth quarter, but a repeat of the spring sales surge is unlikely in light of the low saving rate.

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*These figures include the armed forces in the labor force.

Housing-sector activity appears to be flattening. Sales of new single-family houses have fallen 15% from their May-June peak, and starts of these units–flat for the past four months–have not increased appreciably even since early in the year. In contrast, construction of multi-family units has continued to expand, with starts of such units reaching a 800,000 per-annum rate in August, the best performance since the REIT-aided boom a decade ago. Developers, however, are finding that it takes significantly longer than earlier in the recovery to rent newly completed units.

During the first three quarters of the recovery, changes in inventories accounted for nearly half of GNP growth. At the bottom of the recession in the fourth quarter of 1982, inventories valued in constant 1972 dollars were being reduced at an annual rate of $22.7 billion. By the second quarter, the rate of decline had eased to $5.4 billion, and it appears that inventories were accumulated at a significant rate in the third quarter. Further inventory accumulation is likely in light of low inventory-sales ratios. Even substantial inventory building in 1984, however, would not repeat the contribution to growth that took place during the past three quarters.

Prospects for lower rates?

The increase in the Federal funds rate to 9½% from 8½% during the spring and summer–and the accompanying lift to interest rates across the board–was caused primarily by two factors: the strength of the economy and the Federal Reserve's concern about above-target growth in money supply. With the pace of the recovery slowing–and with all three measures of the money supply within target–the upward pressure on interest rates has subsided. In addition, fears of higher inflation that had begun to intensify during the summer have been partially allayed by the recent easing in commodity prices and by the continued moderation of wage increases.

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983				*1984*
	Q1	*Q2*	*Q3*	*Q4*	*Q1*
Real GNP	2.6	9.7	6.5	4.4	4.4
Real consumer spending	2.9	10.0	1.9	4.6	3.9
Real business-capital outlays	−1.5	8.0	6.3	6.3	7.0
GNP deflator	5.5	3.3	3.7	4.2	4.7
Consumer prices	−0.4	4.2	4.6	4.3	4.8
Real disposable personal income	2.9	3.5	6.0	4.2	2.2
Saving rate (%)	5.4	4.0	4.9	4.9	4.5
Housing starts (Millions)	1.7	1.7	1.8	1.8	1.7
Auto sales (Millions)	8.4	9.2	9.3	9.7	10.0
Unemployment rate (%)	10.4	10.1	9.4	9.1	9.0

Note: 1983 Q1 and Q2 data are actual.

Whether these developments will simply stabilize interest rates for a time or produce a further reduction in rates is the key question in financial markets. The outcome will depend on the extent of the cooling of the recovery and on movements of the monetary aggregates. At this time, however, indications are that interest rates are more likely to go down than up.

Credit-Market Congestion: Postponed — For Now

THE summer's anxiety over an impending clash between private and Treasury borrowing needs–heightened by the warnings of Federal Reserve Board Chairman Volcker in July –has given way to renewed optimism in credit markets. A cooling off of spring's torrid economic growth, some reduction in the volume of Treasury financing, lackluster business credit demand, and slower growth in the monetary aggregates have all contributed to an upbeat mood. But will it last?

A sector-by-sector analysis of credit flows suggests that the markets will be able to handle new credit demands without strain into early 1984 in an environment of fairly stable interest rates.

Demand for credit is expected to decline in the period ahead since much of the spring surge in borrowing can be traced to the second-quarter spurt in sales of consumer durables and in housing and to accelerated borrowing by states and localities that will be largely self-extinguishing in the second half. Moreover, with the recovery moderating and near-term inflation well contained, Fed policy is not likely to turn more restrictive in the near term. But by late 1984, the Treasury's still voracious appetite for funds seems likely to coincide with more robust growth in private-credit needs. At that point, congestion could become a concern for credit markets.

Despite enormous federal deficits–and an expanding economy–growth in 1983's credit demands seems likely to be in line with the Federal Reserve's goals for such growth. New credit needs of domestic nonfinancial borrowers in the second half of this year are projected by The Morgan Bank to be $227 billion before seasonal adjustment–a bit lower than in the first half of this year and the last half of 1982 (table on page 4). If this projection for 1983's second half is realized, growth in the Fed's new credit aggregate–domestic nonfinancial debt–would approximate 9¾% between the fourth quarter of 1982 and the fourth quarter of this year, well within the Fed's 8½% to 11½% growth range.

Federal borrowing. Treasury borrowing requirements in the first half of each calendar year are normally much lower than in the second half. This is because individuals and corporations ordinarily make sizable final payments on each year's tax liability in the January-to-June period of the following year. But in 1983, Federal borrowing in the first half will exceed that likely to occur in the last half.

In 1983's first half, individuals made unusually small final settlements by taking advantage of the shelter afforded by Individual Retirement Accounts, and personal tax refunds ran about $5 billion higher than last year. Corporate tax payments net of refunds, moreover, were $10 billion lower in the first half of 1983 than in the same period last year, because tax liabilities fell far short of corporate declarations in 1982. In addition, first half 1983 payments lagged behind the first-half rebound in corporate profits. Thus, despite the recovery, overall first-half tax collections were depressed. Finally, state and local governments bought some $7.4 billion of nonmarketable Treasury securities in the first half to facilitate the refinancing of their high-cost debt. These purchases boosted Treasury financing above the Federal government's credit needs. As a result, Treasury borrowing in this year's first half, at $102.6 billion, was more than double that of the same period a year ago.

The Demand for Credit by Domestic Nonfinancial Sectors

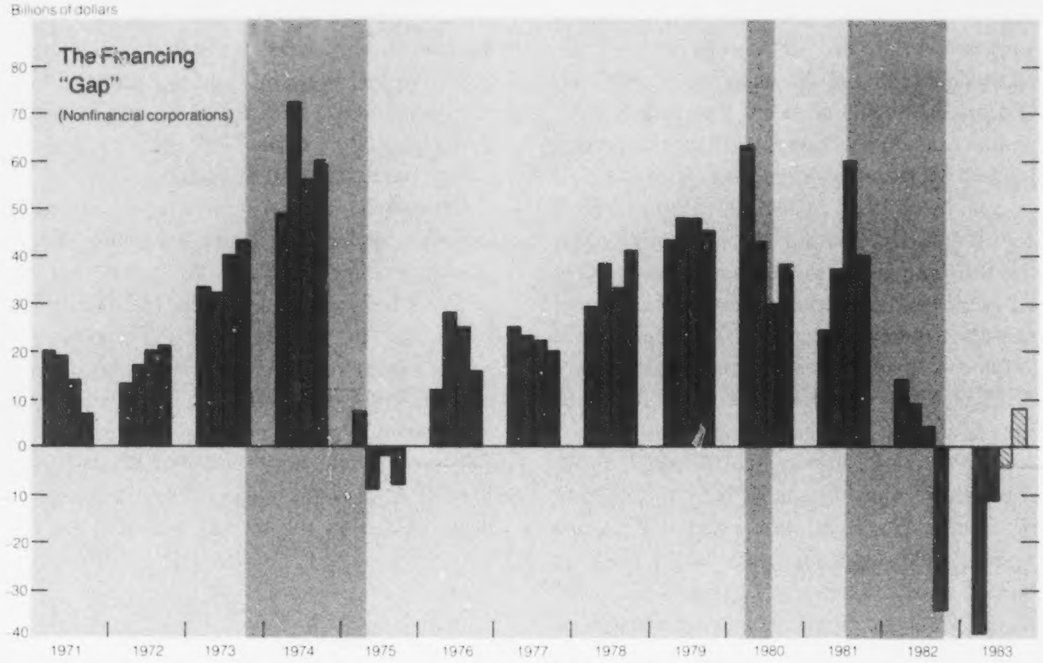
	1981		*1982*		*1983*	
	First half	*Second half*	*First half*	*Second half*	*First half*	*Second* half*
Federal government issues	33.5	54.3	42.3	119.8	102.6	90.0
Federal agency issues**	−.1	−.1	−.6	−.1	0.	−1.0
State and local government issues	9.7	12.2	19.9	30.6	28.2	21.0
Mortgages	62.7	51.7	40.2	42.7	69.0	75.0
Corporate bonds and notes	12.7	19.4	4.8	14.1	9.7	9.0
Other business borrowing (nonfarm)	35.0	43.6	43.4	11.3	−.4	10.0
Consumer credit	6.3	17.8	1.7	16.6	10.2	16.0
All other credit	15.4	13.4	4.2	4.3	9.8	7.0
Total credit demand	175.0	202.2	155.9	239.4	229.0	227.0

Note: Data are not seasonally adjusted. *Estimated. Due to rounding, components may not add to totals.
**Budget Agency Issues and Loan Participations.

In the second half of this year, Treasury credit needs will be increased by the personal tax cuts that took effect in July and by enlarged interest payments. But those increased needs will be swamped by a cyclical pickup in tax receipts, by a $5 billion reduction in spending for agricultural programs, and by temporary shortfalls of perhaps $4 billion in military outlays. Those factors have all contributed to bloated Treasury cash balances. At the end of the third quarter, cash in the Treasury till totaled over $37 billion. In all likelihood, borrowing will slow as those balances are run off. Additionally, the postponement until next January of the payment date for two- and four-year notes to be auctioned in December will reduce second-half 1983 Treasury borrowing by some $7 billion. All in all, the Treasury's cash needs are likely to drop to about $90 billion in the second half—far short of the nearly $120 billion borrowed in the second half of 1982.

State and local. Tax-exempt borrowing in the first six months of this year amounted to $28.2 billion, down a bit from the last half of 1982. The drop, however, would have been much larger had it not been for sharp declines in tax-exempt yields and for postponement from January 1 to July 1 of the requirement that securities be issued in registered form. Both of these factors encouraged a surge in issuance (story on page 8). Most of this tax-exempt borrowing overstates actual credit needs, however, as evidenced by the fact that states and municipalities "parked" the bulk of the proceeds in Treasury securities.

The bunching up of borrowings in the first half has swollen municipal coffers and reduced the second-half borrowing needs of states and localities. Moreover, the issuance of industrial revenue bonds is not likely to accelerate in view of new restrictions on their use imposed by Congress on companies that simultaneously take advantage of accelerated depreciation. As a result, new issuance of tax-exempt securities will likely drop by about 25% in the second half.



The Financing "Gap"
(Nonfinancial corporations)

Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research.

The financing gap is the difference between corporate outlays for fixed investment and inventories and retained cash flow (depreciation plus after-tax profits minus dividends).

Business financing. The surprising strength in investment and sharp swing in inventories (Economy Watch, page 1) are boosting total business financing needs somewhat higher than seemed likely only a few months ago. Still, in comparison with past recoveries, investment and inventory accumulation will likely be slightly below what is typical for the first year of a recovery. Retained cash flow has also risen more rapidly than had been expected, as profits of nonfinancial corporations have soared (up nearly 54% at an annual rate in the first half of 1983).

In the second half, however, growth in such profits will moderate to an estimated 32% annual rate. Even so, the 1983 rise in profits and corporate cash flow will be the strongest of any postwar recovery. As a result, the expected widening of the corporate "financing gap"—the difference between outlays on investment and inventories and retained cash flow—will be considerably narrower than those typical of postwar recoveries. As shown in the chart on this page, nonfinancial corporations are estimated to have accumulated roughly $22 billion more cash than needed to finance capital formation and inventory investment in the four quarters ended September 30. Indeed, it is only in the current quarter that needs for external financing will begin to grow.

That cash stockpile, together with healthy bond and equity markets, enabled corporate treasurers to begin the much-needed restructuring of their balance sheets last spring. The pace of gross bond issuance by nonfinancial companies in the first six months of 1983 was nearly double that of the same period last year. And first-half 1983 gross sales of underwritten public common stock represented a staggering five-fold increase from the volume in the first six months of 1982. While issuance has cooled from that sizzling pace, bond and equity offerings are both likely to pick up in response to the decline in long-term rates from the summer peak. Net of repayments of outstanding bonds and notes, domestic nonfinancial bond issuance in all of 1983 is expected to total about the same as in 1982—$19 billion.

That volume of bond issuance—coupled with heavy gross equity issuance (likely to total $40 billion this year) and low external financing needs—should help moderate the growth in "other" (mostly short-term) business credit demands. Though commercial and industrial loans at commercial banks rose at an 8.6% annual rate in July and August, net nonfinancial commercial paper issuance has only very recently shown signs of life. In addition, the jump in bank loans was due largely to the recent return to inventory accumulation. "Other" net business credit extensions in the second half are likely to be a modest $10 billion, bringing the 1983 total to one-fifth that of 1982.

Mortgage credit. First-half net new mortgage loan volume reflects the key role housing has played in sparking the recovery. At $69 billion, net issuance has jumped to an annual rate 67% higher than that of last year. Massive inflows of deposits to thrifts enabled them to originate an exceptionally large volume of mortgages. Mortgage lending was further encouraged by the continued growth of federally-sponsored mortgage pools that serve as conduits of funds to builders and homebuyers from investors not traditionally in the mortgage markets. Mortgage pools, for example, picked up half of the net increase in mortgages in the first two quarters of 1983. A slowing in housing's growth, however, will reduce the rise in second-half new mortgage lending to only 9% or so; the volume is expected to be about $75 billion.

Consumers. The spring quarter witnessed an explosion of new consumer borrowing. Rapid growth in durables purchases fueled the rise. While slower growth in housing will likely moderate durables' growth, rising discretionary incomes, propelled by employment gains, the tax cut, and still-low inflation rates will buoy consumer spending and thus raise consumer debt. Consumer installment plus noninstallment credit jumped in July by a record $5.4 billion; the expected rise in the second half is some $16 billion.

Market implications

Though the demand for credit outside the federal sector promises to be somewhat above that of the first half, government borrowing requirements through yearend will be considerably smaller than they were in the first two quarters. In that setting, with no broad tightening of Fed policy expected in the period just ahead, prospects are that interest rates will not be subject to any significant upward pressure through the rest of the year.

Some analysts have recently argued that the May-August rise in interest rates was due to heavy borrowing. Actually, the borrowing numbers overstated the volume of credit demand. As already noted, much of the first-half borrowing by states and localities merely reflected an intermediating role—relending borrowed funds to the Treasury. Such intermediation—resulting, in effect, in "double counting" of credit demands—accounted for about one and one half percentage points of the reported 12.3% (seasonally adjusted at an annual rate) of growth in domestic nonfinancial debt. As a result, the second-quarter "surge" in new credit needs was really only a mild acceleration to 10.8% from the 8.9% growth of the January-March period. That rise in growth is easily accounted for by the spurt in Federal borrowing and increases in mortgage and consumer credit extensions. As already noted, those three sources of demand will cool in the months ahead.

In the longer term, however, as the recovery matures into broad-based expansion, a return to credit-market congestion is possible later in 1984. The key reasons: a projected near-tripling in the growth of capital spending, due in part to a turnaround in investment in new structures; an estimated halving of the growth in corporate retained cash flow; and a dramatic slowdown in the projected growth of other (nonbusiness) domestic private saving—from 68% in 1983 to 15% in 1984.

To be sure, rising foreign saving inflows—accompanying a growing current account deficit in the balance of payments—will offset declines in the growth of domestic saving. But large current-account deficits will in time begin to put downward pressure on the dollar, as foreign portfolios begin to bulge with assets denominated in dollars. Higher interest rates next year may well be required to prevent a depreciation of the dollar from eroding foreigners' home-currency returns on portfolios swollen with U.S. assets. Set against a backdrop of increasing structural budget deficits and a pickup in business' financing requirements, the pressure on interest rates seems likely to increase by late 1984.

Brightening Prospects for States and Localities

THE nation's states and localities, which in 1982 posted a combined operating deficit of $3 billion–the first red-ink year since the mid 1970s–are now moving back into surplus.* The Morgan Bank's projection is for an operating surplus of $15 billion in 1983 and for an even larger surplus next year (chart below).

This favorable fiscal performance is an impressive achievement. It has been accomplished despite a severe squeeze on revenues caused by last year's recession and despite major cutbacks in federal aid. The fiscal turnaround reflects the impact of the current economic recovery on tax collections and heroic efforts by many jurisdictions to reduce spending and raise taxes.

The fiscal rejuvenation has positive near-term economic implications. It greatly lessens the need for further revenue increases as the economic recovery proceeds, and it allows considerable room for increased construction spending by states and localities to repair the nation's decaying infrastructure (roads, bridges, tunnels and transportation systems).

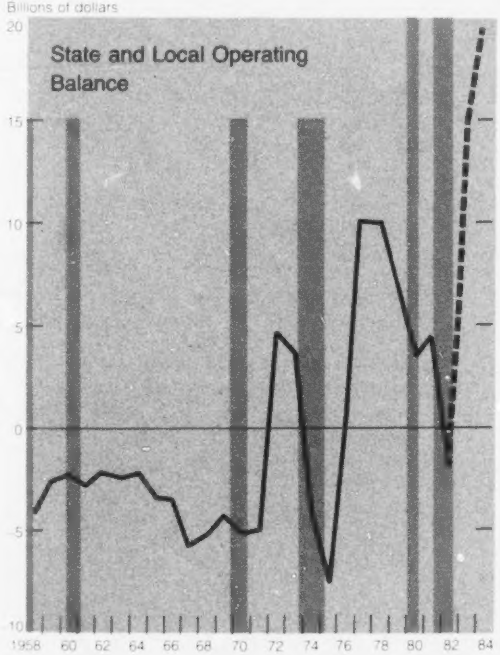
Moreover, the improved fiscal outlook seems likely to stabilize state and local credit ratings–providing an offset to the depressing effects on the municipal securities market exerted by the recent default of Washington Public Power Supply System.

Behind the turnaround

There are three reasons for the turnaround in state and local finances:

Expanding revenue base. Part of the improvement in state and local budgets reflects a strengthening of revenues brought forth by the increase in jobs, income, and retail sales that has occurred since last winter. The effects of the expansion in economic activity alone can be expected to add some $7 billion to $8 billion to state and local tax collections over the next 12 months.

Reinforcing these gains is the shift toward surplus brought about by a determined effort to increase tax rates even during the recession. During the past year, for instance, states raised income and sales taxes and localities boosted property tax rates in order to reduce their deficits. These tax actions represented a reversal of



Note Shaded areas represent periods of recession as determined by the National Bureau of Economic Research. Estimates based on National Income Accounts.

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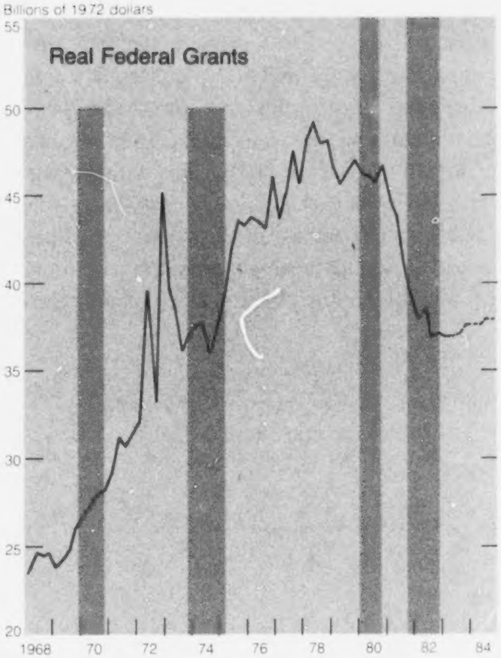
*The operating balance of all state and local governments combined, as reflected in the national income accounts, includes both current and capital budgets; it excludes surpluses registered by state and local pension funds.



Note Shaded areas represent periods of recession as determined by the National Bureau of Economic Research. Estimates based on National Income Accounts.

the drive for tax cuts that had started in the late 1970s. Indeed, in early 1982, taxes were raised by almost $3 billion in 18 states, with over half the increase occurring in income and sales taxes. This tax movement gained added momentum as the year wore on. By the spring of 1983, some 38 states had new levies or had extended temporary increases that had been scheduled to expire. These measures alone are expected to raise an estimated $10 billion for state coffers in the current fiscal year.

Local governments also raised taxes. The growth of property tax collections–which previously had been restrained by tax limitations (such as Proposition 13 in California)–accelerated from less than 1% in the late 1970s to over 13% in 1982. Local officials thus appear to have permitted effective property tax rates to move up, after a decade of decline. In addition, user charges also increased in 1981 and 1982, rising by around 12% in both years.

The fiscal stringency of the localities has shown up in their budget positions. After recording a $1 billion surplus in 1980, localities' surpluses rose to $2¼ billion in 1981. While all the data are not yet available, the recent growth in property and user charges suggests that the surpluses widened in 1982 and will increase again in 1983.

Spending cuts. A second factor behind the

State and Local Activity Over the Business Cycle

(Percent change; compound annual rate)

	*Average of six postwar recoveries eight quarters after trough**	*1980:2 to 1982:2*	*1982:4 to 1984:4*
Total expenditures	8.3	7.4	7.6
Purchases of good and services	8.6	7.3	7.8
Purchases of goods and services (1972 dollars)	3.5	−0.6	2.4
Construction	4.8	−5.1	4.1
Construction (1972 dollars)	1.1	−7.3	−0.3
Payroll employment	3.4	−0.9	1.2
Federal grants	13.7	−1.4	2.7
Operating balance (Billions of dollars)	9.9‡	−1.1†	13.9†

*Trough quarters are 1949:4, 1954:2, 1958:2, 1960:4, 1970:4, and 1975:1.

†Absolute change over eight quarters after trough.

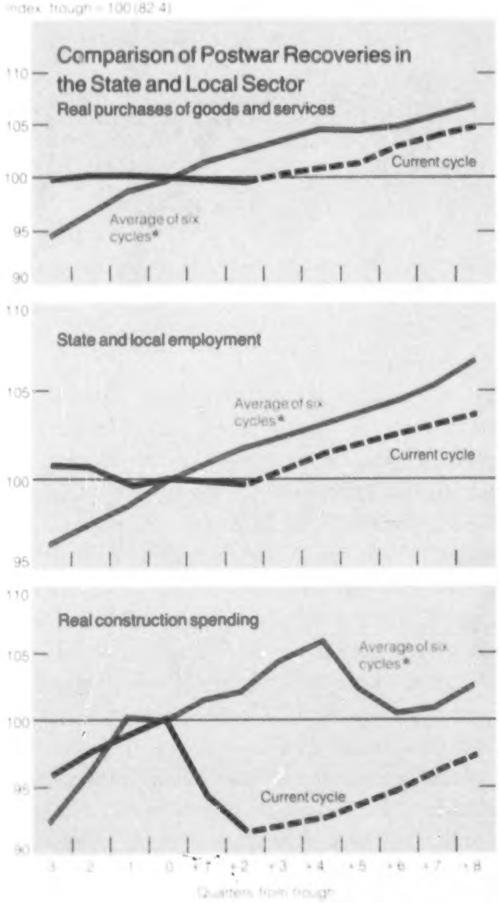
‡Average of last four recessions, due to lack of detailed data on operating balance before 1958.

fiscal turnaround is the fact that states and localities made significant changes on the spending side of their ledgers. Three-fourths of the states, for example, reduced spending below the level originally appropriated during fiscal years 1982 and 1983, according to a survey conducted by the Conference of State Legislatures. Employees were laid off and maintenance and repairs on roads, bridges, and water supply systems were postponed. While the recession increased demands for income-security programs, many states tightened eligibility requirements in an effort to hold the line on expenditures. Thus, the growth of spending by state and local governments, fell from a 10% annual average growth rate between 1978 and 1980 to a 7% average in the past two years. The tightness in spending appears to have continued in the first half of 1983, with outlays rising at only a 4.7% annual rate.

Federal payments. Finally, the decline in Federal grants that occurred in 1981 and 1982 has been replaced by a renewed growth in aid from Washington. This increase in aid should provide a lift to the state and local sector. The five-cent increase in the federal gasoline tax (which became effective April 1, 1983), for example, is bolstering the revenues of the Federal Highway Trust Fund and will provide new money to states for highway and transit construction.

Congress earlier this year also passed a jobs bill that will increase grants-in-aid by about $3 billion over the fiscal 1983-1985 period. These legislated increases in federal aid should offset some of the sharp cuts in outlays set in motion by the massive program consolidations enacted in 1981. Thus, the sharp decline in real federal grants over the past two years is expected to bottom out in 1983 and turn around in 1984 (chart on page 9).

All in all, the rise in payments from Washington and the rise in revenue collections from economic recovery and from legislated tax increases should ease pressures for further reductions in state and local spending. Indeed, many jurisdictions are expected to loosen their purse strings by a modest amount in the year ahead. Construction spending, in particular, should pick up as state and local governments try to repair and rebuild their capital stock (chart below,



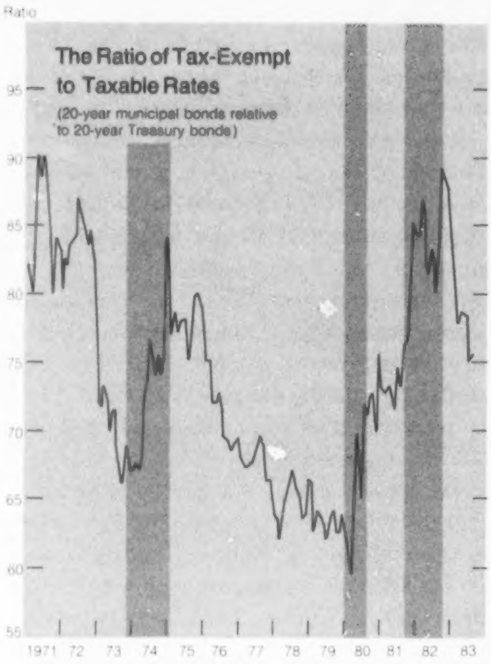
Comparison of Postwar Recoveries in the State and Local Sector

* Six cycles include 1948-1949, 1953-1954, 1957-1958, 1960, 1969-1970 and 1973-1975

table on page 9). The recent sharp increases in public contract awards—a good indicator of future spending—strongly suggest that construction by states and localities is likely to rise well into 1984.

State and local spending thus can be expected to play an important role in sustaining the economic recovery in the year ahead. If realized, this support would be a distinct change from the past three years. During the last two recessions, the state and local sector added to the economy's downward momentum rather than, as in the past three decades, helping to counter the downturn. The growth of inflation-adjusted purchases in the 1980 and 1982 recessions, for example, showed little or no rise as compared to average growth of 7% in the prior recessions. Moreover, during the 1980 expansion and thus far in the current recovery, the state and local sector failed to provide its usual boost to aggregate economic activity. The reasons: reductions in the size of the school-age population, a decrease in the growth of federal aid, and the passage of Proposition 13-type taxing and spending limitations.

But that sluggishness appears to be coming to an end. Real purchases by states and localities in the second half of 1983 now are expected to rise at a 2% annual rate, up sharply from the 1% decline registered in the first half of this year. Over the eight quarters following the recession's trough (in the fourth quarter of 1982), real state and local spending is expected to grow at a 2.5% annual rate, as compared to the 0.6% annual rate drop in the 1980 recovery (chart on page 10). State and local spending thus may be returning to its traditional cyclical pattern of providing support to the economy in both good times and bad.


The Ratio of Tax-Exempt to Taxable Rates
(20-year municipal bonds relative to 20-year Treasury bonds)

Note Shaded areas represent periods of recession as determined by the National Bureau of Economic Research

Even though the outlook is brighter, state and local officials as well as many bond market participants continue to view the future cautiously. Many budget officials were surprised when the predicted economic recovery failed to materialize in 1982 and revenue projections fell short of expectations. The resulting fiscal strains and the desire to avoid being locked into high-coupon long term debt forced many jurisdictions to turn increasingly to the short-term market for funds—issuing, for example, tax- and revenue-anticipation notes. From fiscal 1981 to fiscal 1983, short-term borrowings by states and localities for operating expenses rose by $2.9 billion, an average yearly increase of 25%. A number of jurisdictions even issued tax-exempt commercial paper, with its short maturity and low cost.

Once interest rates fell in mid-1982, states and localities returned to the long term market.

In the second half of 1982 and the first half of 1983, gross issuance of long-term general obligation and revenue bonds was about $92 billion, up some 65% from the comparable 1981-1982 period. Some of the issuance resulted from the desire to refund the high-cost debt issued in 1981 and early 1982. Some also may have been due to an attempt to beat the July 1, 1983 requirement that all municipal debt be registered in the name of the owner.

Four factors suggest that states and localities may issue somewhat less debt over the next 12 months than during the past year. First, a substantial amount of refunding has already been accomplished. Second, a sizable amount of the preregistration activity was probably borrowed from the future. Third, new restrictions placed on the issuance of industrial revenue bonds should reduce corporate use of tax-exempt issues. Finally, a brightening of the fiscal outlook should reduce the need to tap the municipal bond market. The supply side of the market appears to be headed for more normal times.

The same can be said about the demand side, even though some problems continue to linger on. During the past 12 months, the municipal market has been hurt by the partial withdrawal of two key investor groups from the market: property/casualty insurance companies and commercial banks. Together, the two groups purchased 15% of the net new issues–sharply below the almost 70% participation rate recorded in 1980.

Insurance companies withdrew from the market after many underwriting losses resulted in less need to shelter profits by buying tax-exempt securities. At the same time, the Tax Equity and Fiscal Responsibility Act of 1982 dramatically affected the demand for tax-exempt securities by commercial banks. In particular, a new limit on commercial banks' ability to deduct the interest charges to carry municipal debt reduced their appetite for such securities.

A lack of demand and a surge in supply in late 1982 resulted in an increase in tax-exempt rates in relation to those on taxable securities or, expressed differently, a narrowing in the spread between tax-exempt and taxable yields (chart, page 11). That narrowing encouraged individuals and their intermediaries (mutual funds and trust departments) to hold state and local securities.

More recently, the narrow spread between tax-exempt and taxable yields, a massive inflow of deposits into banks, and weak business-loan demand have begun to attract traditional participants back into the municipal market. In the second quarter of 1983, banks' net purchases of $3.2 billion in new tax exempt issues contrasted with net sales of $4.8 billion in the first quarter. The tax-exempt market, like the state and local sector as a whole, thus is beginning to take on a better tone.

New problems

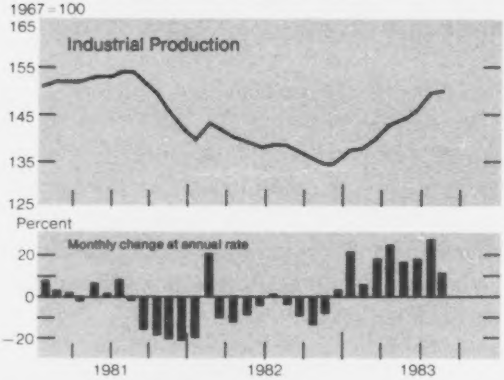
Even with this brighter outlook, the sector is not without some worrisome problems. Not all states and regions, for example, are benefiting equally from the current recovery. West Virginia, in particular, with the highest unemployment rate in the nation, continues to face fiscal difficulties. Louisiana–an energy state with rising unemployment–has drained off most of its large surplus and has utilized non-recurring revenues to balance its budget. And local governments in California still face problems, as expenditures continue to outstrip revenue growth that is still restrained by Proposition-13.

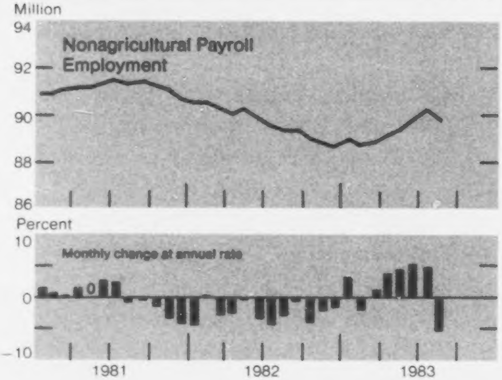
An additional worry for a number of states and localities is that taxpayer willingness to accept relatively high tax burdens may begin to diminish in the year ahead. Hints of future difficulties are provided by the major tax reduction initiatives on the Ohio ballot in November. Moreover, new tax limitations are anticipated in Michigan, Oregon, and Florida in 1984.

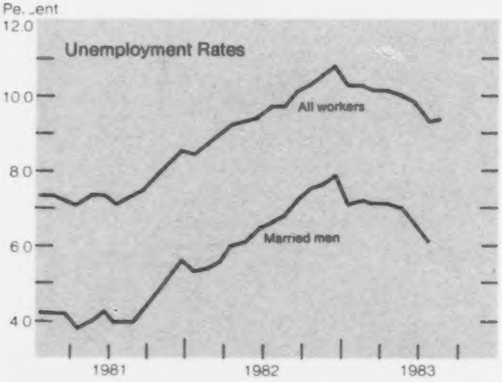
Tax rebellion, should one develop, would complicate efforts to meet the needs of a growing population and an expanding economy. While states and localities have made major progress in trimming the growth of public expenditures, much needed repair on the social capital stock has been neglected. The bill for repairing and rebuilding the nation's infrastructure over the 1983-to-1990 period has been estimated by the Congressional Budget Office at nearly $120 billion (in 1982 dollars). Failure to maintain the social capital stock will reduce the nation's potential growth rate by undermining efficiency and productivity.

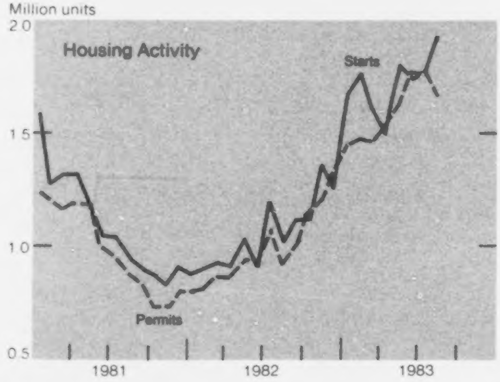
Fortunately, federal, state, and local officials are increasingly aware of the problem. Still, in the face of tax protests that are beginning to resurface, officials will face a major challenge in convincing voters that infrastructure repairs and maintenance are vital to the future economic health of the nation.

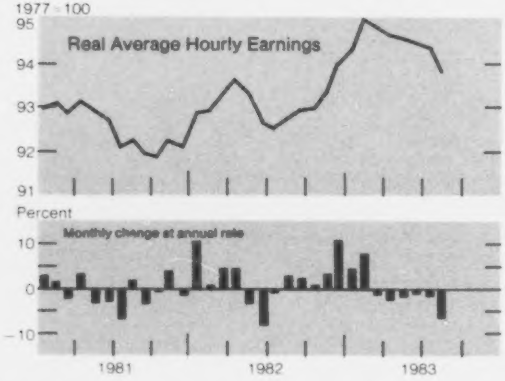
ECONOMIC INDICATORS

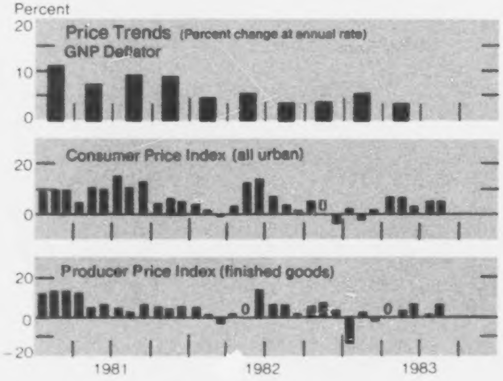






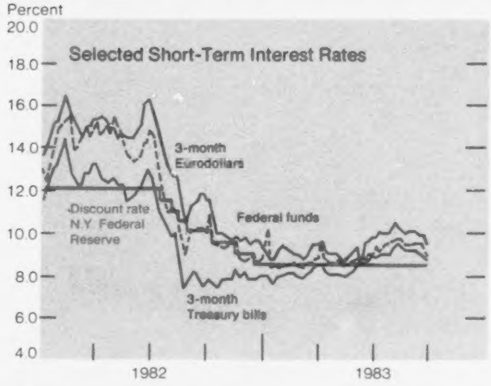


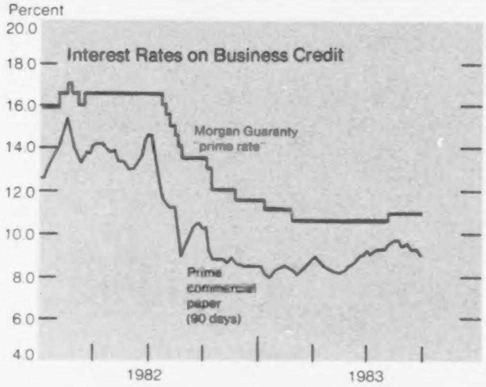


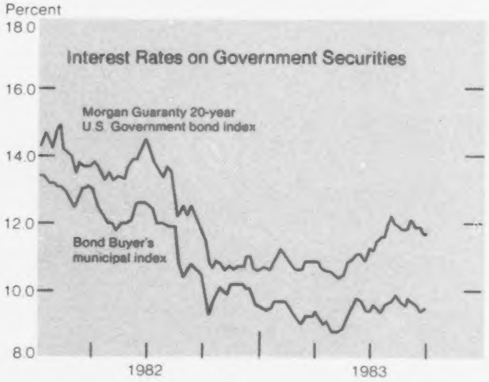


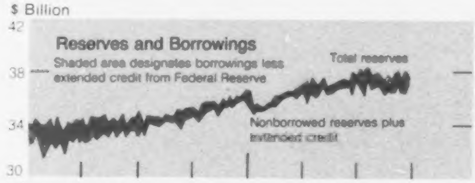
Note: All data are seasonally adjusted. Hourly earnings are adjusted for overtime in manufacturing and for interindustry employment shifts.

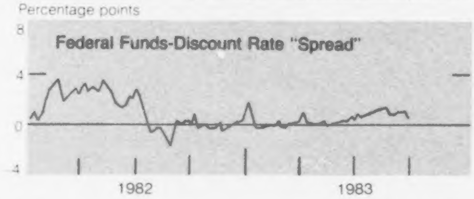
MONETARY INDICATORS

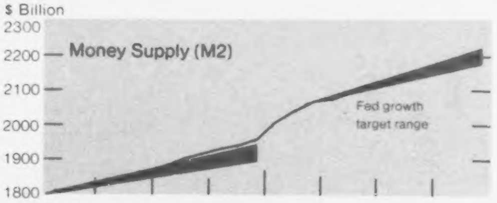


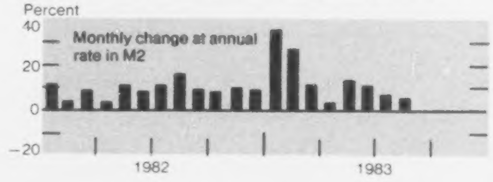


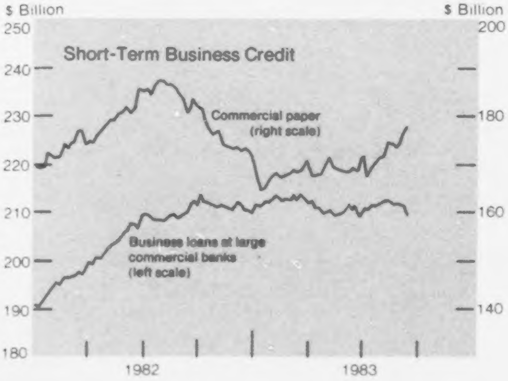












Note M2 equals M1 plus overnight RPs and Eurodollars, general purpose and broker/dealer money market fund balances, money market deposit accounts, savings and small time deposits (net of IRA/Keogh balances). The 1983 M2 growth target is measured from an average February - March base. Business loans are net of bankers' acceptances. All data except interest rates and member bank borrowings are seasonally adjusted.

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Morgan Holdings Corp., Wilmington
Morgan Bank (Delaware), Wilmington
Morgan Trust Company of Florida N.A., Palm Beach
Morgan Futures Corporation, New York, Chicago, London

Morgan Guaranty Trust Company of New York

23 Wall Street, New York, NY 10015 *Member, Federal Deposit Insurance Corporation*

New York banking offices: 23 Wall Street, Fifth Avenue at 44th Street, Madison Avenue at 58th Street, Rockefeller Plaza at 50th Street

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J.P. Morgan (Suisse) S.A., Geneva
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  Subsidiary: Morgan Guaranty International Bank (Cayman) Ltd., George Town
Morgan Guaranty International Bank (Bahamas) Ltd., Nassau
Morgan Guaranty International Finance Corporation: 37 Wall Street, New York, NY 10015
  Subsidiaries (wholly owned except as noted)
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  J. P. Morgan Investment Management Pacific Limited, Hong Kong
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  Morgan Guaranty S.A.E., Madrid
  Morgan Guaranty Finance Limited, Hamilton, Bermuda
  Morgan Guaranty Pacific Limited, Singapore
  Morgan Guaranty (Switzerland) Ltd, Zurich
  Morgan International Finance (Italy) S.p.A., Milan
  Affiliated company (50% equity and 33⅓% voting interest)
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